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IMPLEMENTING WALL STREET REFORM: ENHANCING BANK SUPERVISION AND REDUCING SYSTEMIC RISK

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

EXAMINING WALL STREET REFORM

JUNE 6, 2012

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C O N T E N T S

WEDNESDAY, JUNE 6, 2012

WITNESSES

IMPLEMENTING WALL STREET REFORM: ENHANCING BANK SUPERVISION AND REDUCING SYSTEMIC RISK

WEDNESDAY, JUNE 6, 2012

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order. This hearing is part of the Committee's continued oversight of the implementation of the Wall Street Reform Act, and it is also an opportunity to discuss with our bank regulators the implications of the massive trading loss recently announced by JPMorgan Chase, one of our Nation's largest banks. When a bank with JPMorgan's solid reputation announces that it lost billions of dollars on a large trade reportedly designed to reduce the firm's risks, it reminds us that no financial institution is immune from bad judgment.

While the JPMorgan trading loss does not appear to have caused systemic problems, it is a clear reminder that Wall Street continues to need better risk management, vigorous oversight, and, if the rules are broken, unyielding enforcement. To repeal or weaken Wall Street reform and defund the cops enforcing it would take us back to the days before the financial crisis of 2008.

Wall Street reform was a response to the crisis caused by a lack of consumer protection, reckless behavior in the financial sector, and regulators who failed to take action in time. We now have an agency solely focused on consumer protection, tough new rules to end negligent and reckless practices by some on Wall Street, and regulators armed with new powers to ensure the safety and soundness of the banks they supervise.

The regulators are also in the process of enhancing the standards for our Nation's largest banks through increased capital requirements and more judicious liquidity and leverage standards.

Wall Street reform also requires regulators to sharpen their focus on the largest and riskiest financial institutions. All the regulators joining us today are members of the Financial Stability Oversight Council, a body created to monitor risks facing our financial system. Most here are also all working on the Volcker Rule to prohibit proprietary trading with Government-insured deposits, and the

FDIC continues to work diligently to implement the living wills requirements and establish the Orderly Liquidation Authority for global, large, complex financial institutions.

Similarly, while there is a need for strong regulation of all financial institutions, Wall Street reform recognizes that small community banks should not be treated the same as the largest banks. Because large, complex banks take on the most risk and pose the greatest threat to our economic stability, they should be required to pay their fair share into the Deposit Insurance Fund. Likewise, the small banks that did not cause the crisis should not have to pay for the risks taken on by their larger competitors, and their assessments have been lowered accordingly.

A one-size-fits-all approach is not appropriate, and many parties have raised concerns about challenges faced by small community banks. I hope to hear from our witnesses today about the steps they are taking with regard to small banks.

Some have claimed that the Wall Street Reform Act was not the right set of solutions to the crisis and that it asks our regulators to micromanage the activities of the firms they regulate. I disagree. To restore confidence in our financial system after the crisis, we need more, not less, scrutiny of Wall Street's activities. The Wall Street Reform Act has built a stronger oversight framework that closes regulatory gaps, enhances financial stability, and better protects consumers, investors, and taxpayers.

And so despite the repeated calls to deregulate and to defund by those who ignore the costly lessons of the financial crisis, completing the implementation of the Wall Street Reform Act must be, and remains, a top priority for this Committee.

In that vein, I look forward to hearing from the witnesses here today about the progress they have made to complete implementation of Wall Street reform, as well as the actions they have taken regarding the JPMorgan trading loss, and their thoughts on the potential implications of the loss for supervision and Wall Street reform rulemakings going forward.

I also want to thank Ranking Member Shelby and my colleagues here on the Banking Committee for all their input and cooperation over the past several months. At a time when most of America thinks that Congress is in a gridlock, the Committee has been very busy getting things done on the Senate floor. The bipartisan Export-Import Bank reauthorization passed with broad support and was signed into law by the President last week. We passed in the Senate this Committee's bipartisan Iran sanctions bill. Both nominees for the Federal Reserve Board of Governors received floor votes, and we helped to secure the passage of their confirmation. We passed the bipartisan transportation bill in the Senate, and the Transportation Conference Committee meetings are currently ongoing with the House. And we passed a 60-day extension of the National Flood Insurance Program, and we have a commitment from the Senate's leadership to bring the Banking Committee's bipartisan NFIP reauthorization bill to the floor in the coming weeks.

In addition, there is another important legislative matter facing this Committee: helping responsible homeowners refinance into lower interest rates at no cost to the taxpayers. We have already had several full Committee and Subcommittee hearings on refi-

nancing proposals. I would like to take a bipartisan approach similar to the other Committee-passed bills of this Congress where we work together on a bipartisan vehicle with amendments limited to those related to the underlying bill. I am hopeful that my colleagues will agree to move forward in this manner as well so that we can help responsible homeowners and help the housing market rebound.

With that, I turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. Thank you for calling this very, very important hearing. And to our panelists today, welcome again. I think we have spent a lot of time together, but probably we will spend a lot more in the future right here.

Today the Committee will hear from the financial regulators who supervise our Nation's banks. The safety and soundness of our banking system depends on your efforts. It was not long ago that our banking system began to collapse, notwithstanding the presence of a large and vigorous regulatory structure. Hence, I believe it is critical that this Committee conduct rigorous oversight to ensure that the financial regulators do not repeat the mistakes of the past.

As the primary regulator of the national banks, the Office of the Comptroller of the Currency is responsible for ensuring the safety and soundness of our largest banks. This means that the OCC supervises JPMorgan Chase, whose recent $2 billion plus trading loss has been in the news. And because taxpayers basically guarantee JPMorgan's deposits, the American public, I believe, has a right to know whether these trades threatened or could have threatened the solvency of the bank.

In addition, this Committee, I believe, has an obligation to determine whether this loss reveals any operational or regulatory weakness that could cause more serious problems in the future.

Next week, here in this Committee JPMorgan CEO Jamie Dimon will appear to explain his bank's actions there. Today I would like to hear the OCC's views on what happened at JPMorgan. In particular, the Comptroller, I believe, should give us his assessment of whether these trades ever threatened, as I said earlier, the safety and soundness of one of our Nation's largest banks.

Banks are in the business of taking risks, and losses, as we all know, are an inescapable part of risk taking. Job creation and economic growth depend on banks' taking risks. It is the job, I believe, of regulators to prevent banks from taking risks that expose taxpayers.

Some people have used JPMorgan's loss as an opportunity to argue for a stronger implementation of the Volcker Rule. But no matter where you stand on the Volcker Rule, this argument, I believe, is a bit premature. Most importantly, was the OCC's current authority sufficient to prevent these trades from putting taxpayers at risk, if they did? If so, did the OCC properly use the authority that it has? I look forward to hearing the Comptroller's answers to these questions, among others.

Also with us today is the Acting Chairman of the Federal Deposit Insurance Corporation, who is no stranger to this Committee. We

have been told that Dodd-Frank will prevent future taxpayer bailouts and that insolvent financial institutions will be allowed to fail. Yet under the FDIC's plan for implementing Dodd-Frank's resolution authority, short-term creditors would still be bailed out. The lesson we all should have learned from the TARP bailouts is that creditors of a failed firm should bear its losses. Today I hope that Acting Chairman Gruenberg can reassure this Committee that the FDIC's resolution authority will not institutionalize Government bailouts.

Regrettably, the FDIC is not the only regulator that has taken actions that may institutionalize too big to fail. The Financial Stability Oversight Council, led by Treasury, and the Federal Reserve Board have recently used the authority granted by Dodd-Frank to designate several companies as systemically important and are preparing to designate a larger group soon. I believe the danger presented by such designations is that the market will view it as an implicit guarantee that the Federal Government—the taxpayers—will not allow the designated institution to fail. This was the same problem that arose with Fannie and Freddie and ultimately has led to about a $200 billion taxpayer bailout, and more to come. I would like to hear from the Treasury and the Federal Reserve Board as to how the designation process will eliminate rather than create too-big-to-fail companies.

Finally, we will also hear from the Director of the Bureau of Consumer Financial Protection. The Bureau's regulation and supervision will impact the safety and soundness of our banking system, I believe. But unlike other bank regulators, the Bureau is not required to consider safety and soundness when it writes rules or takes actions against banks. I think this is becoming apparent as the Bureau's proposed rule will impose huge costs on banks and have created serious confusion about what banks need to do to comply with consumer protection laws.

For example, the Director of the Bureau has unilateral authority to declare products to be "abusive." However, the Bureau has said that it will not write a regulation to clarify what the term "abusive" means. Think about it. The refusal to write a rule stands in stark contrast to the Director's statements that the Bureau would give banks clear rules of the road—in other words, certainty in what they could do and what they could not do.

The refusal of the Bureau, a lot of us believe, to issue clear rules means that banks will have higher costs, more exposure to lawsuits, and less effective operations, something I do not think Congress intended. In the end, it will be consumers that will pay the price in the form of higher costs, less access to credit, fewer choices, and more paperwork from less efficient banks. But this should come as no surprise to the regulators here. After all, it was not our regulators or the banks that paid for the poor regulation and practices that led to the financial crisis. It was the taxpayers and the consumers.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Shelby.

This morning, opening statements will be limited to the Chairman and the Ranking Member to allow more time for questions from the Committee Members. I want to remind my colleagues that

the record will be open for the next 7 days for opening statements and any other materials you would like to submit. Now I will briefly introduce our witnesses.

Neal S. Wolin is Deputy Secretary of the U.S. Department of the Treasury.

Dan Tarullo is currently serving as a member of the Board of Governors of the Federal Reserve System.

Thomas Curry is Comptroller of the Currency. Welcome, Mr. Curry, to your first hearing before the Banking Committee since your confirmation as Comptroller.

Marty Gruenberg is the Acting Chair of the Federal Deposit Insurance Corporation.

And Richard Cordray is Director of the Consumer Financial Protection Bureau.

I thank all of you again for being here today. I would like to ask the witnesses to please keep your remarks to 5 minutes. Your full written statements will be included in the hearing record.

Secretary Wolin, you may begin your testimony.

STATEMENT OF NEAL S. WOLIN, DEPUTY SECRETARY, DEPARTMENT OF THE TREASURY

Mr. WOLIN. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to appear today to discuss implementation of the Dodd-Frank Act. The Act's full implementation will help protect Americans from the excessive risk, fragmented oversight, and poor consumer protections that played leading roles in bringing about the recent financial crisis.

That crisis, and the recession that accompanied it, cost nearly 9 million jobs, erased a quarter of household wealth, and brought GDP growth to nearly negative 9 percent.

Today our economy has improved substantially, although more work remains ahead. More than 4.3 million private sector jobs have been created over the past 27 months and, since mid-2009, our economy has grown at an average annual rate of 2.4 percent.

As part of our broader efforts to strengthen the economy, Treasury is focused on implementing the Dodd-Frank Act to build a more efficient, transparent, and stable financial system.

Core elements of the act include tougher constraints on risk taking and leverage; a new orderly liquidation authority to resolve large, interconnected firms facing failure; comprehensive oversight of derivatives; stronger consumer financial protections; and new measures to promote transparency and market integrity.

Substantial progress has been made since the Dodd-Frank Act was enacted. Regulators have proposed or finalized nearly all the major rules related to the core elements of reform.

Treasury's implementation responsibilities include the Secretary's role as Chair of the Financial Stability Oversight Council and standing up the Office of Financial Research and the Federal Insurance Office. Excellent progress has been made setting up each of these entities.

Treasury is also charged with coordinating the Volcker rulemaking. We are working with the regulatory agencies toward a final rule that effectively prohibits proprietary trading activities

and limits investments in—and sponsorships of—hedge funds and private equity funds.

The lessons learned from the recent failures in risk management at JPMorgan Chase will be an important input into efforts to design the Dodd-Frank Act reforms, including a strong Volcker Rule.

The Volcker Rule explicitly exempts from the prohibition on proprietary trading the ability of firms to engage in "risk-mitigating hedging activities in connection with and related to individual or aggregated positions . . . designed to reduce the specific risks to the banking entity."

To that end, the final rule should clearly prohibit activity that, even if described as hedging, does not reduce the risks related to specific individual or aggregate positions held by a firm.

Losses at JPMorgan raised questions that go beyond the Volcker Rule as well. Among other things, regulators should require that banks' senior management and directors put in place effective models to evaluate risk, strengthen reporting structures to ensure risks are assessed independently and at appropriately senior levels, and establish clear accountability for failures in risk management. Regulators should make sure that they have a clear understanding of exposures and that banks and their senior management are held accountable for the thoroughness and reliability of their risk management systems.

Ultimately, the true test of reform is not whether it prevents firms from taking risk or from making mistakes. It is whether our financial regulatory system is tough enough and designed well enough to prevent those mistakes from harming the economy or costing taxpayers money. We all have an interest in that outcome.

Our ability to achieve it depends on the authority and the resources to enforce tougher capital, leverage, and liquidity requirements on banks and the largest, most complex nonbank financial companies.

It depends on implementing the full framework of protections on derivatives, from margin requirements and central clearing of standardized derivatives to greater transparency into risks and exposures.

It depends on providing the SEC, the CFTC, the CFPB, and other enforcement authorities with the resources to police manipulation, fraud, and abuse.

It depends on our ability to safely unwind a large firm without the broad collateral damage and risk to the taxpayer that we experienced in 2008.

And it depends on making sure that no exception built into the law is allowed to undermine the impact of the tough safeguards we need.

The challenges our economy has continued to experience since the financial crisis in 2008 only increase our commitment to implementing lasting financial reform.

Recent failures in risk management provide an additional reminder that comprehensive reform must continue to move forward. The Administration will continue to resist all efforts to roll back reforms already in place or block progress for those that remain to be implemented. The lessons of the financial crisis should not be left unlearned or forgotten, nor should American workers—or

American taxpayers—be left unprotected from the consequences of future financial instability.

Thank you.

Chairman JOHNSON. Thank you.

Governor Tarullo, please proceed.

STATEMENT OF DANIEL K. TARULLO, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. TARULLO. Thank you, Mr. Chairman, Senator Shelby, and Members of the Committee.

You are all probably familiar with the concept of the law of the instrument, although you may know it instead as the law of the hammer. If you are holding a hammer, everything looks like a nail.

Now, that concept itself is supposed to be a warning not to use reflexively a familiar tool in response to every problem. But I must confess that the longer I taught and wrote in the area of financial regulation, the more convinced I became of the centrality of strong capital standards to a sound financial system.

My time at the Federal Reserve has not changed my mind. On the contrary, a series of events, most recently the JPMorgan loss announced a few weeks ago, has only reinforced my conclusion.

A bank with a strong capital position can absorb losses from unexpected sources, whether those be external shocks to the economy, the insolvency of important counterparties, or failures of risk management within the firm. Strong capital buffers ensure that losses are borne by shareholders of the bank, not by taxpayers, either directly through some form of bailout or indirectly through a major negative effect on the economy resulting from a bank's failure.

So I am especially pleased that tomorrow afternoon the Federal Reserve Board will be considering a final regulation implementing more rigorous capital requirements for market risks of banking organizations, as well as proposed rules to increase the quantity and quality of capital held to satisfy regulatory requirements.

These regulations are the product of cooperative efforts by the Federal Reserve, the OCC, and the FDIC over the last few years to achieve strong international capital arrangements, and over the last several months to draft joint domestic regulations. Along with our stress tests, annual capital reviews, and anticipated systemic risk surcharges, these regulations will form a complementary set of requirements for the country's largest institutions.

While capital is central to good financial regulation, it is not all there is. There is truly more than a hammer in the regulatory toolbox, which also includes noncapital rules, market discipline, and supervisory oversight. We continue to work on rules, notably the enhanced prudential standards for larger institutions required by sections 165 and 166 of the Dodd-Frank Act, and the Volcker Rule. The latter, of course, involves multiple agencies, which have now finished reviewing the 19,000 comment letters and are considering potential modifications of the proposed rule.

The enhanced prudential standards elicited considerably fewer letters but still present a number of important issues for consideration before final regulations can be implemented, including how to tailor the application of these standards to firms of different sizes and complexity.

As to market discipline, one development of note is that the Federal Reserve and FDIC will in the coming months be reviewing the resolution plans to be submitted by large firms in accordance with the joint rule adopted by the two agencies last year.

Finally, with respect to supervision, the Federal Reserve continues to build a more centralized, horizontal, and data-driven approach to supervision of our largest institutions. The LISCC process, as we call it, has run the stress tests and other horizontal supervisory exercises since its establishment in 2010 and is extending its activities to coordinate other supervisory processes more effectively.

Thank you for your attention, and I would be pleased to answer any questions you might have.

Chairman JOHNSON. Thank you.

Comptroller Curry, please proceed.

STATEMENT OF THOMAS J. CURRY, COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. CURRY. Thank you, Chairman Johnson, Ranking Member Shelby, and Committee Members. Thank you for the opportunity to update you on our implementation of the Dodd-Frank Act, its impact on the supervision of national banks and Federal savings associations, and our response to JPMorgan Chase's losses reported in May.

Among the many Dodd-Frank-related rulemakings underway are rules to remove references to credit ratings from OCC regulations and a final market risk rule. In addition, I will soon approve publication of a set of proposals to implement Basel III. The OCC is also reviewing comments received in response to proposals regarding the Volcker Rule and stress tests required by the Dodd-Frank Act. These rules, when final, will make important contributions to the regulation of financial institutions in this country.

The Dodd-Frank Act and other reforms have already done much to strengthen our financial regulatory framework. Translating these reforms into improved soundness of our banking system and fair treatment of bank customers requires strong, effective supervision, which is a theme that flows throughout my testimony and will mark my tenure as Comptroller.

The OCC has already begun efforts to heighten supervisory expectations for the largest institutions we oversee. This process includes increasing our awareness of risks facing banks and the banking system, ensuring these risks are understood and well managed, and raising our expectations for management, capital, reserves, liquidity, risk management, and governance. It will take time to achieve these objectives, and we must remain vigilant in maintaining our course. My testimony provides considerable detail about these efforts.

I want to use the remainder of my time to provide an overview of what the OCC is doing in response to the JPMC losses reported in May. We are the primary regulator of JPMC's national bank where the activity leading to its losses occurred, and we are responsible for the prudential supervision of the bank.

Since early April, the OCC has been meeting with bank management to discuss JPMC's Chief Investment Office positions, risk management, and controls. As the positions deteriorated, discussions turned to corrective actions and steps necessary to mitigate and reduce the risk of the bank's positions. We and the Federal Reserve are conducting reviews in the bank and are sharing information with the FDIC and other regulators.

We are also undertaking a two-pronged review of our supervisory activities. The first component focuses on evaluating the adequacy of current risk controls at the bank, informed by their application to the positions at issue. The second component evaluates the lessons learned from this episode that could enhance risk management processes at this and other banks. Consistent with our supervisory policy of heightened expectations for large banks, we are demanding that the bank adhere to the highest risk management standards.

We are not limiting our inquiry to the particular transactions at issue. We are assessing the adequacy of risk management throughout the bank. We are using these events to broadly evaluate the effectiveness of the bank's risk management of its CIO function and to identify ways to improve our supervision. If corrective action is warranted, we will pursue appropriate informal or formal remedial measures.

JPMC's national bank has approximately $1.8 trillion in assets and $101 billion in Tier 1 common capital. Given that scale, the loss by JPMC affects its earnings but does not present a solvency issue. JPMC has improved its capital, reserves, and liquidity since the financial crisis, and those levels are sufficient to absorb this loss. It is also worth noting that the events at JPMC do not threaten the broader financial system, and the bank's effort to manage its positions is not creating an unusual risk of contagion.

There has been much discussion about whether these JPMC activities would be permissible under the proposed Volcker Rule. While it is premature to reach any conclusion before our review is complete, this episode will certainly help focus our thinking on those issues.

I appreciate the opportunity to appear before the Committee, and before closing, I want to stress my commitment to ensuring that the OCC continues to enhance supervision. I look forward to updating you throughout my tenure on how we are achieving strong, effective, fair, and balanced supervision of national banks and Federal thrifts.

Thank you.

Chairman JOHNSON. Thank you.

Chairman Gruenberg, please proceed.

STATEMENT OF MARTIN J. GRUENBERG, ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. GRUENBERG. Thank you, Chairman Johnson, Ranking Member Shelby, and Members of the Committee, for the opportunity to testify today on the FDIC's efforts to enhance bank supervision and reduce systemic risk.

The most important new FDIC authorities under the Dodd-Frank Act are those that provide for the orderly resolution of systemically

important financial institutions. Since passage of the Dodd-Frank Act, the FDIC has taken a number of steps to carry out its new responsibilities. First, the FDIC established a new Office of Complex Financial Institutions to carry out three core functions: to monitor risk within and across these large, complex firms from the standpoint of resolutions and risk to the Deposit Insurance Fund; to conduct resolution planning and develop strategies to respond to potential crises; and to coordinate with regulators overseas regarding the significant challenges associated with cross-border resolution.

For the past year and a half, this office has been developing internal resolution plans in order to be ready to resolve a failing systemic financial company.

The FDIC has also completed the basic rulemaking necessary to carry out its systemic resolution responsibilities. In July of last year, the FDIC Board of Directors approved a final rule implementing the Title II Orderly Liquidation Authority. Last September, the FDIC Board adopted a rule, jointly issued with the Federal Reserve Board, regarding bank holding companies with total consolidated assets of $50 billion or more, as well as certain nonbank financial companies that the Financial Stability Oversight Council may designate as systemic, to develop, maintain, and periodically submit resolution plans to regulators. These are the so-called living wills.

With the joint rule final, the FDIC and the Federal Reserve have started the process of engaging with individual companies on the preparation of their resolution plans. The first plans, for companies with nonbank assets over $250 billion, are due in July.

Section 210 of the Dodd-Frank Act also requires the FDIC to "coordinate, to the maximum extent possible" with appropriate foreign regulatory authorities in the event of a resolution of a covered financial company with cross-border operations. Although U.S. SIFIs have foreign operations in dozens of countries around the world, those operations tend to be concentrated in a relatively small number of key foreign jurisdictions, particularly the United Kingdom. Our initial work with foreign authorities has been encouraging. In particular, the U.S. financial regulatory agencies have made substantial progress with authorities in the U.K.

In addition to the provisions relevant to systemic risk, the Dodd-Frank Act also contains a number of other provisions that may have a more direct effect on community banks. For example, the Dodd-Frank Act made changes to the FDIC's deposit insurance program, which were implemented soon after enactment, that generally work to the benefit of community institutions. The first of these was the rule to implement the act's provision to permanently increase the insurance coverage limit to $250,000. The FDIC has also implemented the Dodd-Frank Act requirement to redefine the base used for deposit insurance assessments from deposits to assets. When this provision was implemented in the second quarter of last year, aggregate premiums paid by institutions with less than $10 billion in assets declined by approximately 33 percent.

Many community bankers have expressed concern about the Dodd-Frank Act rules and other regulatory actions that would impact their ability to compete in financial markets. In response, the

FDIC is undertaking a series of initiatives related to the future of community banks. We are holding a series of roundtables with groups of community bankers in each of the FDIC's six regions around the country. The FDIC's Division of Insurance and Research is undertaking a comprehensive review of the evolution of community banking in the United States over the past 25 years. Additionally, I have asked the FDIC's Division of Risk Management Supervision and the Division of Depositor and Consumer Protection to review the examination process for both risk management and compliance supervision, as well as to review how we promulgate and release rulemakings and guidance, to see if we can improve our processes and communications in ways that benefit community banks.

Mr. Chairman, that concludes my oral statement. I would be glad to respond to questions.

Chairman JOHNSON. Thank you.

Director Cordray, please proceed.

STATEMENT OF RICHARD CORDRAY, DIRECTOR, CONSUMER FINANCIAL PROTECTION BUREAU

Mr. CORDRAY. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today as part of this panel of my colleagues. As the Director of the Consumer Financial Protection Bureau, I am committed to being accountable to you for how we carry out the laws that Congress enacted, and we are always happy to have the chance to discuss our work with you. This is the 18th time that the new Bureau has testified before either the House or the Senate, and I am pleased to be here again today. My testimony will focus on the areas that you specified in the letter inviting me to testify at this hearing.

To begin with, you asked about our bank supervision program. We have been focused on recruiting and hiring the best team we could find to supervise financial institutions with our focus on consumer protection. We are blessed with great talent: Steve Antonakes, the former Commissioner of Banks in Massachusetts, leads our bank supervision team; Peggy Twohig, the former Associate Director of the Division of Financial Practices at the FTC, leads our nonbank supervision team. Our examiners are working to ensure compliance with Federal consumer financial laws, and they may seek corrective actions to redress violations and remediate harm to consumers.

We have met with many supervised institutions to see how they operate and how they approach compliance. We are engaged with State banking regulator to establish communication and share information to reduce compliance burden. To promote transparency, we published our Examination Manual, along with other examination procedures covering particular products and services.

On Monday, the CFPB and the Federal prudential regulators, as referenced earlier, released a Memorandum of Understanding that clarifies how we will coordinate our supervisory activities to minimize unnecessary regulatory burden, avoid unnecessary duplication of effort, and decrease the risk of conflicting supervisory directives.

Our responsibility under the law, unique among the Federal regulators, is to achieve evenhanded and reasonable oversight of both

banks and nonbank firms that compete in the same consumer finance markets. We take a consistent approach to examining both, using the same procedures for the same products and services.

In addition to mortgage lenders, mortgage servicers, payday lenders, and private student lenders, we will soon finalize a rule to allow us to examine the larger participants in the debt collection and credit reporting industries as we develop our nonbank supervision program further.

The second topic you identified for this hearing is my statutory role on the Financial Stability Oversight Council. As you know, Congress designated the CFPB's Director to serve as one of 10 voting members of the FSOC. The U.S. consumer finance market represents over $20 trillion in loans and deposits and, hence, it is central to the stability of domestic and global capital markets.

Because we share the responsibility of regulating financial institutions with some of our FSOC colleagues, our mutual participation furthers our efforts to maintain a collaborative approach. Participation on the FSOC also provides a broader vantage point on the kinds of triggers and vulnerabilities that pose larger risks to the financial system. I have found this to be valuable as we work toward a sound and vibrant financial system that protects consumers, supports responsible providers, and helps safeguard the broader economy against systemic risk.

Third, you asked how our statutory obligations affect our regulation of community banks. As you know, the Consumer Bureau does not generally examine any banks with less than $10 billion in assets and does not enforce the law against any such banks. We do have the authority to adopt rules that can affect community banks as well as larger banks.

We will help community banks around the country by our new oversight of nonbank firms. I have heard from community bankers who refuse to make an ill-considered mortgage loan, only to see customers go down the street and get a loan from someone else who did not uphold the same standards. The other lender often required no documentation of income and engaged in no recognizable form of underwriting, but still managed to sell bad loans into the secondary market. Once bundled into securities, those loans crashed both the financial system and the economy.

Consistent application of consumer financial laws will promote safety and soundness of the financial system. Over the next year, the Bureau is required to adopt new mortgage rules that protect consumers. Many of these rules are intended to return to sound underwriting standards and sound customer service, practices that are traditional at our good community banks.

As we develop these regulatory initiatives, we know that one size does not fit all. When it makes sense to treat smaller institutions differently from larger institutions, we have pledged to consider doing so. We are implementing small business review panels on several of our mortgage rules and find the input from small providers to be helpful in calibrating our proposals.

When I became Director of the Consumer Bureau at the beginning of the year, I barely knew my colleagues on this panel. Now, 5 months later, from our work together in various roles on various bodies such as FSOC, I have come to know and respect them all.

Our team is glad to be working with their teams and with the Members of this Committee to strengthen and support a sound and vibrant financial system.

I am happy to answer any questions you may have. Thank you.

Chairman JOHNSON. Thank you. I would like to thank all of our witnesses for their testimony. As we begin questions, I will ask the clerk to put 5 minutes on the clock for each Member.

Mr. Curry, it is clear from your testimony that JPMorgan lacked the proper controls to mitigate such a large loss. Was this a failure in risk management? If so, what should the bank have done differently?

Mr. CURRY. Thank you, Mr. Chairman. In essence, we believe that the issue at JPMorgan Chase is one of inadequate risk management within the Chief Investment Office. We have been focusing on potential gaps or deviations from accepted standards of risk management within that particular office and looking to see whether similar gaps exist in any other areas of JPMorgan's risk management architecture.

Chairman JOHNSON. Mr. Curry, the OCC has dozens and dozens of examiners at JPMorgan. First, did your agency check the risk management and internal controls of all aspects of the bank, including the Chief Investment Office, before this event? Or did you miss this? And, second, while regulators are not in the position to review every single trade, what assurances can you give us that the bank regulators will be able to monitor situations where large trades, whether done for hedging or other purposes, could bring down a firm or have a systemic impact on the broader economy?

Mr. CURRY. One of the major focuses of our examination and supervision activities is risk management. We look at risk management in the entire organization and within key areas where there is a substantial risk facing the institution. That process is intended to go across the entire organization in those key areas.

In this particular case, we are looking at whether there were gaps within our assessment of the risks and the risk controls in place in the CIO office. We are in the process of evaluating that in our ongoing examination.

The point I would make in terms of our focus on risk management is that it is one part of the overall approach to identifying risks within the organization. As Governor Tarullo mentioned, a key component of how we assess and mitigate risks in the institutions is the institutions' capital levels, their level of reserves, and their liquidity.

In the case of JPMorgan Chase, both their capital levels and liquidity are substantially higher than they were at the beginning of the financial crisis, and as I mentioned in both my oral and written comments, they are more than sufficient to withstand the reported losses in this particular area.

We are continuing to review, as part of one of the two prongs of our ongoing review, what exactly transpired with the trading operation within the CIO's office, and we are looking to make sure that there were appropriate limits and controls on those activities in that area and how they compared to other similar areas within the organization.

Chairman JOHNSON. It is important that Wall Street reform implementation is completed to enhance financial stability and reduce systemic risk. Secretary Wolin, just to be clear, it does not seem to be that the JPMorgan trading loss was systemic. Do you agree? And what do you believe are the implications of the recent losses at JPMorgan on the Wall Street reform rulemakings that have yet to be completed?

Mr. WOLIN. Thank you, Mr. Chairman, for that question. Obviously, the loss at JPMorgan Chase was a big loss and one that, as Mr. Curry suggested, will affect shareholders. But we concur in his judgment that it is not about the solvency of the firm or, for that matter, the stability of the broader financial system.

I think what is clear is that the lessons that we all learned from what happened at JPMorgan Chase will serve as important lessons and insights into the range of Dodd-Frank implementation work to come, whether it is the Volcker Rule or questions about risk management or enhanced prudential standards or, for that matter, capital. I think this incident underscores the need for us to pay attention to examples like this in order to learn those lessons, both with respect to Dodd-Frank implementation and, as I suggested earlier, the broader efforts of supervision that are ongoing.

Chairman JOHNSON. Secretary Wolin, are regulators better coordinated and prepared after Wall Street reform to deal with external threats to our financial stability and economic growth like the euro zone crisis? What steps are you taking in response to this crisis?

Mr. WOLIN. I think there is no question, Mr. Chairman, that the existence of the Financial Stability Oversight Council has given Treasury and the various banking and market regulators of the U.S. Government an opportunity to constantly monitor financial markets and the exposures of our banks and our broader financial system to what is going on in Europe. The Financial Stability Oversight Council has spent a lot of time on Europe and thinking through what its implications are and might be to our financial system. That work, of course, is ongoing. For the first time, this Council really gives the range of relevant entities of the U.S. Government the capacity to share perspectives, to work together in engaging counterparts in Europe to make sure that we are as well prepared and have thought through the various contingencies that might be necessary.

Chairman JOHNSON. Governor Tarullo, do you have anything to add to this?

Mr. TARULLO. Mr. Chairman, with respect to European preparation, I would just say that one thing about the euro zone problems is they have been with us for some time, as a result of which we have been able to regularize a system of oversight of U.S. financial institution exposures and activities in Europe. Right after the first Greek problems arose in May of 2010, on an ad hoc basis we began looking at them. Over time we have been able to put in place a system that allows us to check the positions and exposures of individual firms against aggregated data, whether from market sources or from supervisory sources, just to make sure that both we and the firms have a handle on what is going on. Other than that, I would concur with what Secretary Wolin said.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you.

I think it is kind of a given here—from what I read and what I know, the stress test JPMorgan went through and so forth—that they have more than adequate capital. I have been told that they would have to sustain losses 40 times, in other words, $70, $80 billion, and they would still be standing. Is that about right, Governor Tarullo?

Mr. TARULLO. Senator, in the stress test, what we did with the trading book was to assume an instantaneous shock based on a very adverse scenario, which entailed trading losses of $28 billion. We also assumed over the period of the stress test credit losses of $56 billion. The sum of those gives approximately the number you indicated.

Senator SHELBY. Comptroller Curry, tell us, just walk us through from what you know, what was going on at JPMorgan. You know, were they managing risk? Were they making money? Were they doing a combination? Everybody has got to measure risk, but, in other words, what was really going on? You had people on-site, right?

Mr. CURRY. That is correct.

Senator SHELBY. So they took a position. Was that a position to manage something they had already done? Could you explain that to us?

Mr. CURRY. That is actually the key question that we are trying to address, Senator, what actually happened in this particular investment strategy, and it is a very complicated investment strategy both in terms of its size as well as complexity.

We are looking to determine what the actual strategy behind that investment scheme was and also if there were any other factors that were driving that strategy other than attempting to mitigate known risks in the bank's portfolio.

Senator SHELBY. But whether it is the banking arena or some other arena, but especially in the area of derivatives and so forth, you take a position, somebody else has another position, right?

Mr. CURRY. Yes.

Senator SHELBY. So if you win, you are looking great, you are looking smart. If you lose, you are maybe having a bad day. But you are not trying to take risk out of the market, are you?

Mr. CURRY. Not necessarily.

Senator SHELBY. What are you really trying to do? From my perspective, I think banks ought to be able to take risk. They ought to manage those risks. The regulators ought to make sure that they know what is going on from your perspective and the Fed's perspective of any huge risk they take, that it might endanger the taxpayer. A lot of us—maybe not everybody, but a lot of us are worried about the taxpayer and bailouts and future bailouts. JPMorgan, as strong as they are, it seems from your testimony and others' and what we know, was never in any danger if they lost $2 billion or $4 billion or what. That is a lot of money to me, and I guess it is a lot of money to them. But what did the Comptroller's office know? And were you on top of things? How many people did you have at JPMorgan kind of supervising or watching this?

Mr. CURRY. Let me address the issue of the supervisory strategy with respect to risk management, first, Senator.

Senator SHELBY. OK.

Mr. CURRY. Number one, we are looking for the institution to identify and address the potential for a serious risk within the organization. We are really not looking to eliminate all risk. If you did so, you would not have a bank. The nature of a bank is to manage risk and to be profitable.

The role of capital is really to absorb those areas where risk is either unavoidable or occurs just because of the nature of the business. And in the case of JPMorgan's national bank, which we supervise, there is ample capital. There is over $101 billion worth of capital backing just the national bank, not the holding company.

With respect to the actual supervision of JPMorgan Chase, we have 65 individuals who are our core team of examiners who are resident at the institution. On top of that, we are able to draw upon a considerable reservoir of skilled individuals with expertise in a variety of credit market—capital markets and other areas that are brought in as targeted exams on an as-needed basis. We also work in connection and cooperation with the Federal Reserve System, which also supervises the holding company.

In terms of this particular investment situation at the CIO's office, we did begin to examine this early in April. Our interest and concern intensified during the month as losses increased within the portfolio up to the point that the institution itself announced the significance of the losses that were incurred.

Since that point in time, our focus has been on managing and monitoring the bank's efforts to mitigate or de-risk that particular portfolio with the objective of ensuring that there is a soft landing of that particular position, to minimize both risk to the institution and ultimately to the Deposit Insurance Fund.

Senator SHELBY. When do you think you will finish your analysis of what really happened in all this?

Mr. CURRY. We hope to do that as quickly as possible, and we also hope to use our findings to inform us as to what potential implications there are for the other institutions that we supervise in our large bank cadre of institutions.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you very much.

Mr. Curry, you have 65 personnel devoted to supervision. How many are in London?

Mr. CURRY. We have five individuals who reside or are housed in our London office.

Senator REED. And they are responsible for how many institutions in London?

Mr. CURRY. They are responsible for any national bank that has a global operation, especially with the presence in London, like a London branch office.

Senator REED. So how many would that be, roughly?

Mr. CURRY. That would be—I will give you the exact number, but it would be roughly a half dozen institutions.

Senator REED. A half dozen. How common is it to have the risk office of a national bank located outside of the United States?

Mr. CURRY. In this particular case, the risk office is actually housed in New York where the global operations of the CIO office are housed. So from a supervisory standpoint, our focus in supervising that and other global issues is really directed from our resident team in New York.

Senator REED. One of the impressions you get from reading the press, though, is that the CIO office in London actually had significant responsibilities with respect to the overall risks to the bank. In fact, the justification that has publicly been made is that they were taking these hedged positions, taking these investment positions to protect the bank from the overall portfolio of the bank, which is an essential risk operation. Can you explain?

Mr. CURRY. The individuals who are responsible for managing the risk and establishing the parameters for the activities that may occur in the London office are housed in New York, and that is where the physical focus of our activity has been.

Senator REED. And they reported directly to the chief management or——

Mr. CURRY. The chief executive officer, yes.

Senator REED. And you are confident from your review that they had complete authority to countermand or contradict or direct the operations in London?

Mr. CURRY. One of the focuses of our review is to determine the accountability, the involvement of management in supervising the design of the risk management controls and their monitoring of it.

Senator REED. When the model for risk was changed, were you aware of that change? Did you evaluate the new model? It took place prior to your assuming these duties, I understand that. You came on board about April——

Mr. CURRY. Nineth.

Senator REED. The 9th, and April 6th was the first indication of difficulty. But was that—I think VaR is the term—model evaluated by OCC?

Mr. CURRY. There are hundreds, if not thousands, of models that are employed by large financial institutions to measure and monitor a variety of risks or other functions in the institution. But under the authority of the applicable capital regulations, Basel regulations, we are required to approve their capital-related models. There are other models that may be at issue here, management-related models or other models that would have been involved in this particular situation. We would not have had an express approval requirement of those models, but we would likely have been aware of them, and we are looking at our procedures for evaluating other types of models that are used by an institution such as JPMorgan Chase.

I would point out that a year ago last April, the OCC did publish written formal guidance on the use of models by OCC-supervised institutions, and that guidance does outline the pitfalls and areas in which banks and bank management must assess in the use of models in measuring risk throughout their organization.

Senator REED. Thank you.

Mr. Wolin, right now we face a serious challenge in Europe with European banks who seem to be in a much more adverse condition than the United States banking industry based on capital and

many other measures, as in Governor Tarullo's testimony. To what extent has Dodd-Frank improved our banking situation vis-a-vis the Europeans and put us in a better, stronger position?

Mr. WOLIN. Senator, I think that both Dodd-Frank and the ability of the Financial Stability Oversight Council to come together and discuss and understand these things, but also the work of the Fed and other regulators sitting at this table to undergo the stress tests that have been at the core of making sure that our banking system is well-capitalized and well-cushioned from the kinds of exposures it might otherwise have, have been important aspects of our being in a much better position than we were before Dodd-Frank and, frankly, in a much better position than our counterparts in Europe.

Senator REED. Is that your view, Governor Tarullo?

Mr. TARULLO. Yes, Senator. Beginning in 2008 and with the hearings on reform that were conducted by this Committee and your counterparts in the House in 2009 there was a sea change in attitudes and orientation both with respect to existing authorities and the use of new authorities. As Secretary Wolin indicated, particularly with stress testing and capital requirements, which of course are embedded now in Section 165 of the Dodd-Frank Act, we all have a much better handle on the positions that our banks will have in the case of a tail event, which is to say the very bad "if" low probability outcome.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Mr. Chairman, thank you, and thanks for the hearing. And I do hope we are successful in having a markup on the Menendez-Boxer bill and that it is a real markup, and hopefully it will happen soon.

I know that in any big piece of legislation, 2,400 pages, there are going to be some good attributes. I know that from my perspective, as we get further and further in the rearview mirror, it is more evident to me that in many ways Dodd-Frank was a political response to a—instead of real reform in so many ways, and I do hope that when this season is over, with everybody talking about it being the best thing since sliced bread, we will actually move on to exploring some real reforms down the road.

Mr. Tarullo, I do thank you for talking about capital. I do think that that is our best buffer against financial institutions having trouble, and I think that has been a contribution.

Mr. Gruenberg, I appreciate you coming in and talking the other day about orderly liquidation.

I do think, Mr. Chairman—I do not know how many people have gone through the FDIC proposed rules on resolution, but the word "liquidation" is throughout Title II. I know Senator Warner knows that well. And I think we have found that it is anything but liquidation, and it really is only dealing with the holding company these institutions will continue. And, again, I just think it would be great for us to understand that and maybe think about whether there should be a Chapter 2 to Title II.

But let me move on to the issue at hand. I think it is a fool's errand to think that regulators are going to be ahead of, you know,

bankers, especially in these highly complex organizations, and the notion of having a regulator beside every banker is, again, a fool's errand. And I really think we have charged you all with a lot of things we should not have charged you with in the first place.

But the real question to me—I know that, look, JPMorgan lost $2 billion. I think over a 2-year period they could lose like $80 billion and still be OK. And yet we still have not deal with the $200 billion that taxpayers really lost with the GSEs. I know people may be looking at this hearing and wondering why we are having it. The reason I think it is important is this is a real live example of what Volcker may or may not be. And I know that determinations are being made about Volcker, and since we have all the regulators here—and I will start with you, Mr. Wolin, and actually ask each of you, what does this mean, "risk-mitigating hedging activities in connection with and related to individual or aggregated positions or contracts"? You all know what the rest of it says. But what does that mean? Does an institution rightfully, once Volcker is in place—by the way, we all understand Volcker is not in place today, so it has no relevance whatsoever as it relates to what happened to JPMorgan. But what does that mean? If an institution has tremendous exposure in Europe through whole loans, just normal loan-making activity, does it or does it not have the opportunity, once Volcker is put in place, to hedge against a downturn in economic activity or just activities there that may be adverse to the bank? I would just like for you all to go across and tell me what this means. And is portfolio hedging something that you envision to be something that can happen or cannot happen after Volcker is fully implemented? We will start with you, Neal.

Mr. WOLIN. Senator, I think as the statute says and you quoted it, the right question to ask is: Is it related to individual or aggregate positions? If you are hedging something that is related to that, then it is permitted. If it is something other than that, then it is not.

I think, the question of portfolio hedging depends a lot on what you mean by portfolio hedging. If you are, quote-unquote, hedging some macro risk that is not related, as the statute requires it to be, to individual or aggregated positions and the risks that come from those, then it is not permissible, our read under the statute. But, of course, in the end the regulators, with our coordination, will have to work through exactly the technical issues of what that means. They put out a proposed rule and 18,000 or so comments came in. They are working through that right now. But I think the question is not really whether it is portfolio hedging or not because the statute does not talk about portfolio hedging. It talks about whether it is associated with individual or aggregate positions that the firm has actually taken and put on their books.

Senator CORKER. And if you would, as you go through, I assume that in order to have a political response to what has just happened during this political season, we could end up making regulations on hedging that make some of the highly complex organizations, if we are going to keep them like they are, even more risky. Is that correct?

Mr. WOLIN. Well, the goal here is to allow hedging that relates to risks that are associated with the positions of the firm, and in

that respect, it is risk reducing. What we do not want to have done and what the Volcker Rule is about, of course, at its core is to not allow activity, proprietary trading activity, with the firm's money that the rest of us, the taxpayers, are ultimately potentially on the hook for making whole.

Senator CORKER. That is what I thought you would say. Thank you.

Mr. TARULLO. Senator, at the last hearing, we had a discussion of the distinction between proprietary trading and market making, and I think what we are facing now is the distinction between proprietary trading and a hedging trade. When you asked what does that provision, which is basically taken from the statutory language and put in the regulation, mean, at least with respect to hedging, what the proposed rule would do would be to put in place both some substantive guidelines for trying to distinguish between hedging of individual or aggregated positions on the one hand, or proprietary trading on the other. And perhaps as importantly, put in place a set of risk management reporting and documentation requirements.

So, in essence, if a firm said we are doing this because it is a hedge, they would be required to explain to themselves, importantly, as well as to the primary supervisor, what the hedging strategy was, how it was reasonably correlated with the positions that they were hedging, and how they would make sure that they did not give rise to new kinds of exposures.

So I think you ask absolutely the right question. What does that mean? And that is the reason why in the proposed regulation there is an elaboration of both some substantive guidelines but also some risk management and documentation requirements.

Mr. CURRY. I would simply state that from a strictly supervisory standpoint, I think we expect all banks, large or small, to have robust and comprehensive assets liability management policies and practices in place.

Senator CORKER. And that includes portfolio hedging.

Mr. CURRY. It would depend on the risks in that particular institution that they are facing, and it could include that. But the issue, I think, as Governor Tarullo mentioned, is really, is there robust risk management in place with controls and limits that allows these risks to be addressed and mitigated without introducing additional risk? And I think that is the concern or the issues that the NPR is trying to address.

Mr. GRUENBERG. Senator, I think the central issue here is that hedging is a risk management activity to reduce risk to the institution as opposed to the activity that would get into a speculative nature where you are really trying to generate income. And I think the whole goal would be—and I think this has been the point that has been made—creating a set of controls in which you can monitor the activity so that the important legitimate hedging activity goes forward. If you are getting into riskier speculative activity, you want to be able to identify that. I think that is important for the institution to be able to recognize and important for the regulators to recognize.

Senator CORKER. Mr. Chairman, I know my time is up, and I realize that the consumer agency is not particularly involved in that

aspect, but I thank you all. And I do hope that the political pressures of what has happened do not cause regulators to end up doing something different than what they think is good for our banking system. And I do hope down the road we will look at some real reforms that may work for us a little bit better and not put all the onus on having a regulator beside every banker.

Thank you.

Chairman JOHNSON. Thank you.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. I want to pick up a little bit where my friend Senator Corker left off.

Mr. Curry, one of the things you had said was that you are still here months after at least looking into some of these JPMorgan activities, trying to determine their strategy. And I believe Governor Tarullo said that one of the results of what you envision a Volcker Rule being implemented might be is that determining this assessment of whether your hedging strategy would have to be laid out, in effect, ahead of time to make a determination of whether it fit within the boundaries of appropriate hedging or bled into proprietary trading. So do you think whether this particular Morgan transactions fell in or out of the Volcker restrictions or not, would the very nature of having this, in effect, sharing of strategy beforehand have perhaps given your office some more guidance? And, Governor Tarullo, if you want to comment on that as well.

Mr. CURRY. I think the point I would like to make in regards to the discussion on the Volcker Rule and JPMorgan Chase, we do not know all the facts. I think that is important before you make any judgments as to whether or not the rule, if it were in effect, would have been applicable in this particular instance. I would like to emphasize this was a risk management issue, regardless of whether or not the Volcker Rule was in play. And the issues really are similar in the sense that, were there appropriate management controls in place in advance of the strategy, were there procedures and reports that enabled management to assess the risks initially and as they may have developed in the course of the execution of that particular strategy.

So I believe that in any event, it is still a risk management issue, regardless of the Volcker Rule.

Mr. TARULLO. Senator, I think the Comptroller has been addressing the question of whether this is a proprietary trade, and I think he is saying he does not have information right now that would allow him to say whether, if Volcker were in effect, it would have been a proprietary trade.

My point, though, is regardless of what we conclude about the actual nature of this particular set of transactions, if this proposed rule had been in place, if the hedging exception were to be invoked by a firm, they would have had to ensure that the kinds of risk management that Comptroller Curry speaks of would have been in place, and they would have been required to document it. And I suspect we are going to find in this case that there was an absence of documentation both within the firm and in reporting to——

Senator WARNER. You would have perhaps a little more guidance on aggregate hedging. I mean, clearly I think there is a value in aggregate hedging in terms of your portfolio, instead of hedging

each individual trade, but you would have had at least perhaps a little clearer guidance.

Mr. TARULLO. I think that that is the intention of these additional provisions in the regulation, and then, of course, the ongoing supervisory challenges to make sure that the information that is received is scanned and reviewed properly.

Senator WARNER. Let me move to a different subject because my time is running out. Again, to Governor Tarullo and Mr. Gruenberg, one of the new tools that we have tried to put in place—actually that Senator Corker and I worked on—is these living wills. And as we move down that path, I would like both your comments in terms of have you had the tools you need to kind of evaluate the back and forth on creation of living wills. And to what standard are you going to hold the institutions? In a sense, this living will will demonstrate how they would unwind themselves? Are you looking at that in kind of a blue skies environment? Are you looking at it in the potential real environment we may have with the breakup of the euro? I would like to just get some comments on that.

Mr. GRUENBERG. Senator, the statute itself establishes a standard for evaluating the plans, and that standard is the Bankruptcy Code. And the requirement is that you have to make a judgment as to whether the plan could credibly result in an unwinding of the institutions under the standards of the Bankruptcy Code, and that is sort of the operating premise for the development of the resolution plans.

As I indicated previously, the Fed and the FDIC issued a joint rule last year establishing the criteria for the plans. We have been working with the institutions on their development. Under the rule, the first round of plans—and those will be for the largest institutions, those with assets of over $250 billion—will be due in July. So we have been engaged in a process with those companies in the initial development of those plans. We are going to get the initial submissions in July. Then there will be an extensive process of review of those plans following the submissions.

Mr. TARULLO. The only thing I would add to that, Senator, is that obviously it is not possible to tailor a lot of different resolution plans to a lot of different potential adverse scenarios. That is why our review of the plans that are submitted is going to need to include basic questions about the ongoing structure of the firm; that is, we are not just going to be able to say, if something bad happens on Thursday, will they be able to resolve by Monday morning? We are going to need to ask ourselves whether the drafting and review of the resolution plans shows us that there are structural elements or features of the organization that could be an impediment to achieving that end and, thus, as a matter of current supervisory policy, we need to adjust. That kind of exercise should help provide some more suppleness in response to whatever the risk is that could eventually lead to the firm's problems.

Senator WARNER. Thank you, Mr. Chairman.

Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman. I want to first indicate that I strongly agree with the tenor of the questions that we heard from Senator Corker and Senator Warner with regard to the

Volcker Rule and those aspects. I think we have covered that thoroughly, so I am not going to go into that further myself, but I did want to indicate that that is a direction I would have gone into had we not already had a full discussion of that. And I encourage you to take their comments to heart as we move forward. I am very concerned about how we are moving forward in the regulatory climate right now with regard to the response to things like the JPMorgan issues and others.

I want to just shift the focus for a minute, and, Mr. Cordray, I want to talk to you first. The housing credit market continues to be very tight, and I am hearing a lot of concern about how Dodd-Frank will reduce credit availability through the proposed rules for qualified mortgage that increases liability and qualified residential mortgage that requires a 20 percent downpayment.

I know that last week the CFPB reopened the comment period for the qualified mortgage proposal until July 9th, seeking comments about data that can be used to model the relationship between the borrower's ability to repay and variables such as the consumer's ratio of debt to income.

Is it your intention to also convene a small business panel to discuss the impact of this proposed rule?

Mr. CORDRAY. So thank you, Senator, for the question about the qualified mortgage or ability to repay rule. One of the reasons we did reopen the comment period is that we have recently been able to obtain a significant amount of data from FHFA that gives us a better window into the mortgage market. We are all, I think, quite concerned—and I know all of you are as well—about the direction and trajectory of that market, and this is an important rule in helping shape the future of that market. We want to be clear that we craft a rule that is based on sound data and that does not unduly restrict access to credit, which I think is something we have been hearing consistently from small banks, large banks, community and consumer groups across the country.

Even after the Fed's comment period had closed on this proposed rule, we continued to get immense amounts of comment from different groups, and we thought that we would open up a comment period again to make sure everybody had an even chance at commenting on those issues, including data issues that we have identified in the re-comment proposal. Because this rule was originally proposed by the Fed, the small business panel is not implicated, and if we were to try to convene a whole process, we would miss the statutory deadline Congress has set for us, which is January of 2013, which we fully intend to comply with.

So that is our approach at the moment. We encourage any small provider that wants to take advantage of the renewed comment period—and this is part of the reason why we did it. Those outside the Beltway often do not understand the ways that they can access the agency, and we want them to have full access and full voice in our rulemaking to make sure we are reflecting the entire market.

Senator CRAPO. Well, thank you, and to Mr. Gruenberg, Mr. Curry, and Mr. Tarullo, it would seem to me that because of the qualified residential mortgage is supposed to be more broadly defined than the qualified mortgage, would it be correct to say that

the banking regulators should wait for the CFPB to finish its rules before they move ahead with their risk retention rules?

Mr. GRUENBERG. Senator, I do not know that a judgment has been made on that. I think as a general matter we thought there was a logic in having the QRM follow the QM. So we will have to see. But there is a logic to that.

Senator CRAPO. Mr. Curry, do you agree?

Mr. CURRY. I think that that is a necessary component to the entire package of rulemaking, the QRM and the QM.

Senator CRAPO. Mr. Tarullo.

Mr. TARULLO. It is an interagency process, Senator. If people want to wait, we will wait, too.

Senator CRAPO. All right. I would encourage you to do that.

Mr. Tarullo, recent events have highlighted the difficulty in modeling risk. My understanding is that the Federal Reserve is following or utilizing the current exposure method and that there has been quite a bit of concern about whether that is an accurate method of risk modeling.

Are you considering other models or are you focused on simply staying with the current exposure method?

Mr. TARULLO. I am sorry, Senator. In what context? In the stress test context or in the——

Senator CRAPO. That is my understanding, yes.

Mr. TARULLO. With respect to the stress testing, what we are trying to do in stress tests is make our best judgment as to what kinds of losses would be entailed across the industry.

Senator CRAPO. Let me interrupt.

Mr. TARULLO. I am sorry.

Senator CRAPO. I was mistaken. I was more focused on the single counterparty.

Mr. TARULLO. Oh, yes. OK. That is a different issue, right. That is a calibration issue with respect to the determination of the exposure of a large institution to another institution for purposes of the limits that we will be promulgating. That is one of the topics that is being commented on in the consideration of changes to or potential modifications to the proposed rule on sections 165 and 166. There have been a number of alternatives suggested. The challenge, without trying to signal where we would go because we have not seen all the comments yet, and I certainly have not had a briefing on it. The challenge is going to be on the one hand wanting to have a methodology that tries genuinely to track actual risk exposure while on the other not becoming dependent on modeling within firms, because as we have seen in a number of other contexts, dependence solely upon the modeling and firms can lead you astray, particularly because firms in our observation tend to be much better at modeling VaR and associated kinds of risk assessments for more or less normal times, as opposed to the tail events that we are trying to guard against.

So in thinking about the comments on the proposed rule, we will have to keep both those issues in mind, trying to hew toward what really are the risks associated with the positions on the one hand and on the other hand wanting to make sure that we are not totally dependent on some internal model.

Senator CRAPO. Well, it is another example of where if we model too aggressively one way or the other, we will get it wrong and create unintended consequences, so I encourage you to get it right and focus on these concerns about the accuracy of the current exposure method.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

Does anyone on this panel think that Bruno Iksil, the "London Whale," who ran JPMC's European strategic investment unit, woke up each day trying to mitigate the risk from excess deposits invested between loans and bonds?

Mr. CURRY. That is a related area of inquiry at the OCC.

Senator MERKLEY. So you are inquiring, but you would not argue that case?

Mr. CURRY. Not necessarily.

Senator MERKLEY. No, I would not think anyone would, because he woke up each day as head of the strategic investment unit trying to make money for the bank. And so it is kind of a basic observation.

Small businesses across America—and, Comptroller Curry, I will address these to you, and I will try to ask you to keep your responses crisp so I can try to get through a series of questions. But across America, small businesses are trying to get access to credit. They are highly frustrated. The ability of them to access credit is essential to the recovery of our economy. Does it do damage to our economy to have banks diverting taxpayer-insured deposits into hedge fund investments rather than making loans to families and small businesses?

Mr. CURRY. We at the OCC, Senator, are very supportive of small business lending by the entire spectrum of national banks and Federal thrifts that we supervise, both from the largest——

Senator MERKLEY. Right, but that was not the question. The question is: Is diverting deposits into hedge fund investing rather than making loans damaging to our economy?

Mr. CURRY. I would hope not. I hope that was not the case, would not be the case.

Senator MERKLEY. But it would be if deposits were diverted into hedge fund investing rather than making loans to small businesses. You are hoping it was not the case, but you are saying it would be if that is what happened?

Mr. CURRY. We expect national banks and Federal thrifts to meet the credit needs of their communities, including small business lending. We do not direct exactly how they do that. We assess it from the CRA.

Senator MERKLEY. OK. I will continue then. Thank you. Does it increase systemic risk to have banks diverting taxpayer-insured deposits into hedge fund investments?

Mr. CURRY. I believe that is the intent of the Volcker provisions of the Dodd-Frank Act, and——

Senator MERKLEY. Well, certainly it is the intent, but in your opinion, does it increase systemic risk?

Mr. CURRY. Unrestrained financial risk taking outside a legitimate risk framework is something that we would be very concerned about as a supervisor at the OCC.

Senator MERKLEY. From a common citizen's point of view, when they look at the fate of Long-Term Capital Management, MF Global, AIG, Lehman Brothers, Merrill Lynch, and a host of institutions that survived only because we bailed them out, I think the case is fairly clear that if you are in the hedge fund business, you increase systemic risk; and if you are in the banking world doing hedge funds, you would increase systemic risk. Am I way off base here?

Mr. CURRY. Again, Senator, we would look to the banks engaging in safe and sound lending within the context of banking. To the extent that it was undue risk taking that occurred, we would hope to either have a statutory or regulatory restraint.

Senator MERKLEY. OK. Let me explore it from this angle. Do bank-hosted hedge fund investment units have a competitive advantage over nonbank hedge funds? Because the bank-hosted funds have access to the discount window and they have access to insured deposits. Do they have a competitive advantage over nonbank hedge funds?

Mr. CURRY. I would have to look at the available research to come to a conclusion.

Senator MERKLEY. I would say of course they have an advantage. They have taxpayer-insured deposits and access to the discount window. Is that an observation that is way off mainstream common sense?

Mr. CURRY. I would like to be able to research that subject further.

Senator MERKLEY. OK. In terms of proprietary trading being disguised as risk mitigation, it seems like there are basic things that kind of create red flags. If a company says it is mitigating risk on a long position that is investment in corporate bonds by essentially taking a long position by selling insurance, is that a red flag that maybe this is not risk mitigation after all?

Mr. CURRY. That is something that we would raise red flags and would have to look at.

Senator MERKLEY. How about if a so-called risk mitigation operation is investing in hedge funds, private equity funds? Would that be a red flag that this is not risk mitigation, this is an investment operation, a proprietary trading operation?

Mr. CURRY. That would be another area under general risk management at a minimum that we would be looking at.

Senator MERKLEY. So a potential red flag, it would draw attention.

If a risk mitigation operation is making massive trades that are not identified with specific risks from specific assets, whether individual or aggregated, would that be a red flag?

Mr. CURRY. We would look at that and the other examples you have given very closely.

Senator MERKLEY. OK. So if they are not tightly correlated, something—red flag.

Are you going to support closing the loopholes that the Wall Street banks have been arguing for so they can continue hedge

fund-style operations? Are you going to support closing those loopholes or keeping those loopholes?

Mr. CURRY. That is one of the issues that all the agencies, the banking agencies and the other agencies, are looking at, the proposed NPR on the Volcker Rule. I would add that I think our experience here, as it unfolds with JPMorgan, would help inform our views in the final rulemaking.

Senator MERKLEY. Thank you very much.

Mr. CURRY. Thank you.

Chairman JOHNSON. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman.

I would like to start by also acknowledging Mr. Tarullo's comments about the importance of capital, and I know you have given a great deal of thought to this for a very long period of time and have considered this in a very sophisticated way. And there may be many things you and I may or may not agree on, but I think the emphasis on capital as a general matter is exactly the right direction that we ought to be heading in. And I fear that Dodd-Frank is a profoundly misguided effort to do many, many other things. I have to respectfully disagree with our Chairman, who in his opening comments I think tends to disagree with the characterization of Dodd-Frank, as I have characterized it, as a very explicit attempt to require that regulators micromanage banks. I do believe very much that it is exactly that and that it is guaranteed to fail in that respect. But I want to touch on another topic, if I could.

Mr. Gruenberg, I observed in a recent speech that you stated, among other things, that—and I think this is within context—"the typical path toward the failure of an insured bank starts with bad loans." My understanding is, according to the FDIC's Web site, over the course of 2009 and 2010, there were almost 300 banks that failed—about 297. That is actually quite a high rate of failure, the highest since the early 1990s. Ninety-five percent of these failures were banks with assets of less than $1 billion. And I would just ask you, to your knowledge, how many of them failed because of their proprietary trading activities?

Mr. GRUENBERG. To my knowledge, Senator, none of them.

Senator TOOMEY. None. Not one. Did they fail because they made loans that went bad?

Mr. GRUENBERG. As a general characterization, I would say yes.

Senator TOOMEY. Like virtually 100 percent of the cases, it was because they had bad loans. So would it be fair to say that historically, including to the present day, the biggest risk of banking is the lending activity that is inherent to the banking process?

Mr. GRUENBERG. Yes.

Senator TOOMEY. Do you regulate that at all? Does the FDIC and does the OCC have any regulatory oversight whatsoever over the lending process?

Mr. CURRY. Yes, that is a considerable focus of our examination and supervision.

Senator TOOMEY. Yes, that is what I thought. Lots of regulation, right? Documentation——

Mr. CURRY. And on-site examination.

Senator TOOMEY. Concentration requirements, supervision of the activities. And yet, despite that, 100 percent of the failures of

banks in America in the last 2 years are attributed to bad loans. I am not criticizing the regulatory process. It seems to me that if we have a banking activity, the very nature of which is to take risk in extending credit, some of those banks, especially during tough economic times, are going to fail. And that is unfortunate, but it is acceptable. It is unavoidable. And the real goal of the regulatory regime, it seems to me, ought to be to just ensure that you do not have systemic risk, you do not have the failure of one or more institutions taking down the rest. And this is why I go back to Mr. Tarullo's observation. It seems to me that capital is the greatest assurance that you have less leverage if you have more capital and less systemic—greater ability, of course, to absorb whatever losses might occur. But instead we are going down the direction—and, again, you are forced to implement a law that has been passed, but Dodd-Frank—to the Chairman's point about micromanaging, my understanding is there are 398 rulemaking requirements, 110 of them have been met with finalized rules, another 144 rules have been proposed, yet another 144 have yet to be proposed. And as we all know, but maybe all of our constituents may not be fully aware of, we are talking about rules; we are not talking about an admonition not to play in traffic. We are talking about many, many pages of very dense and complex matters that are associated with each individual rule. The Volcker Rule alone is staggering in its length and complexity. I think it is an impossibility.

Take one little aspect of the Volcker Rule, the exception that is applied to market-making activities. Just in formulating that exception, we have all kinds of metrics that we are going to impose, that regulators are going to decide. They are going to invent limits, for instance, on how much money can be earned from the bid-offer spread versus a subsequent market rule; how much business a market maker must do with end users versus interbank dealers; what kind of asset classes are permitted to trade what kind of risks and under what kind of circumstances. We have to decide whether these limits apply to an individual trader or whether we aggregate trades. It is staggering.

I am concerned that it is going to limit the ability of banks to manage risk. It is going to have a huge cost. It is going to reduce liquidity in the market. And we are doing this while no banks have failed because of proprietary trading.

Oh, and by the way, we create these arbitrary exceptions. It is perfectly OK if you do all the risk taking you like, as long as it is in Treasurys. As someone who once traded fixed-income instruments, I can assure you, you can lose your shirt trading Treasurys just as readily as you can lose your shirt trading corporates, for instance.

So I guess I do not have a specific question about this. I am just very, very concerned that we have created a monster that at my last count, between the Comptroller of the Currency and the Fed, we have over 100 examiners on the ground I guess pretty much full-time at JPMorgan alone. That is before we implement all of these rules.

Mr. Chairman, I have to say I think we have very much taken the wrong direction here, and I hope we will reconsider when we

are in a political environment where it is possible and will consider capital as the essential tool to reduce systemic risk.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Curry, I want to ask you about JPMorgan losing $2 billion, and possibly more, since the OCC was the primary regulator was JPMorgan, and the OCC has a well-deserved reputation for being too cozy with the banks that it regulates. And I know you just got to your new position, so you have an opportunity here to decide what the OCC does in the future.

I find it interesting. You know, what I do not want to see is a repeat of 2008. I know that a free market is essential to our very economic vitality, but there is a difference between a free market and a free-for-all market. And in 2008, what we obviously came to the conclusion of is the consequences of a free-for-all market where the decisions of large financial institutions became the collective risk of an entire country, even though they were not part of making those investment and other decisions, and then all of us had to pay.

And so, you know, I wish we had insisted on capitalization then. I wish we had insisted on a whole host of things that would have avoided 2008 because I will never forget that meeting with Chairman Bernanke and Secretary Paulson where they described largely a series of financial institutions on the verge of collapse and suggested that if they collapsed, not only would they create systemic risk to the entire country, but failure to act would lead us to a new Depression. I do not want to revisit that.

Now, I do not know whether people can forget such quick history because it is recent history, but I do not.

So I know you just got to this position, and I am certainly not blaming you personally for this. But I just have a yes-or-no question. Did the OCC screw up in allowing these JPMorgan trades to happen?

Mr. CURRY. Senator, we are going to critically look at that question. Part of my goal in reviewing what happened at JPMorgan Chase is not just to see what the bank itself did or did wrong, but also how we can improve our supervisory processes at the OCC. So it will be a critical self-review as part of this process.

Senator MENENDEZ. How long is that self-review going to take you to come to a conclusion?

Mr. CURRY. I hope to have it done as quickly as possible, Senator.

Senator MENENDEZ. What does that mean?

Mr. CURRY. I would hope within the next several weeks and no more than a few months. But I do want to reiterate that my goal as Comptroller is to have a strong, effective, and fair supervision at the Comptroller's office, and it is imperative, and the lessons learned from the 2008 crisis are clear to me and to my colleagues at the OCC. We do need stronger capital, which we are getting through Basel III and other rulemakings. We also need heightened expectations, and we are requiring that of the largest institutions we supervise in terms of the banks' management, its awareness of risks, raising their expectations with what we require for minimum

reserves, liquidity, and risk management, and also corporate governance, which is critical as a——

Senator MENENDEZ. I know you say you are going to reserve it, but should not the sheer size of these trades have been a huge red flag for the OCC?

Mr. CURRY. That is an issue; the concentrated nature of the trading and the illiquidity of it are red flags that are clearly apparent now.

Senator MENENDEZ. Well, I just think that for those of us who supported Wall Street reform and do not want to relive 2008, I think every regulator here responsible for implementing the law should know if huge trading losses like this happened at banks after we established the Volcker Rule and capital rules have been written and implemented, then I think the blood will be on all of your hands if the London Whale ultimately goes belly up next time, because in this case I know that the comment is, "Well, they can absorb the $2 or $4 billion," whatever it ends up being. But what if you had through these trades—what is to stop them from losing multiples of that, billions more the next time, or even more significantly, a less well capitalized bank from losses that could bring it down? I just do not see where the circuit breakers are here. I do not see where the ability to ensure that, in fact, that type of decision making does not become the collective risk of all of us again in this country. And I do not think the American people, and certainly this Senator, are willing to go down that road again. I do not know what it takes to get everybody to understand that we are serious of purpose here to ensure that the law is fully implemented.

Now, I know there are those who disagree with the law, but as has been said in the past, Americans are free to disagree with the law, they are not free to disobey it. They are not free to disobey it. And this Senator for one is going to continuously pursue to make sure that we do not relive 2008. And I hope that all the regulators but certainly the OCC understands that.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Moran.

Senator MORAN. Mr. Chairman, thank you very much.

This is one of many hearings that I have participated in that this Committee has held in regard to oversight of the implementation of Dodd-Frank. When I asked for Committee assignments a year and a half ago, I asked for the Banking Committee, was told by some, "Well, you do not want to be on the Banking Committee. Its work is done. They have already passed Dodd-Frank. Its heyday has come and gone." And in my view, oversight, implementation, modification, and alteration of Dodd-Frank is a very important task for this Congress and one that I wanted to fully engage in because the questions of Dodd-Frank are tremendous, certainly directly to financial institutions but, more importantly, to the customers, borrowers, and depositors that we care a lot about.

It is concerning to me that while we continue to have these hearings, my concern is that there is no legislation that then follows the series of ideas that are presented, and certainly I would guess almost every Member of this Committee has expressed, either here in a Committee hearing or in a letter to the regulators, a desire for a different outcome than what has occurred with Dodd-Frank.

And so I think there is a general belief among most everyone on the Committee that there needs to be some alterations in Dodd-Frank, and my hope, Mr. Chairman, is that we will take the opportunity to modify through the legislative process provisions of Dodd-Frank that we think are objectionable or improperly worded or in need of alteration based upon the hearings over a long period of time that we have had on this topic. And I have always been concerned that anytime legislation is proposed that alters the provisions of Dodd-Frank, the allegation is that the person, the Senator, the legislator who wants to make changes is defending big banks, does not care about the consumer. But I cannot imagine a circumstance in which there is not legitimate needs that need to be addressed that are concerns for everyone on this Committee in different areas, different issues. But I think just we need to make certain that the oversight hearings become something more than an oversight hearing, that there actually is a legislative response in which we treat each other with great respect and not with political allegations that we are carrying water for some particular financial institution or segment of the financial industry.

I would encourage, for example, us to mark up the Menendez legislation. Let us go to work and pursue some of the things that we think need to be done in regard to improving the financial regulation, even though we have passed Dodd-Frank, and to prove me right that the glory days of the Banking Committee are not over, that they are ahead of us and we have lots of work to do.

I wanted to ask, I guess a series of you have indicated that as a result of the loss announced at JPMorgan that your position in regard to the Volcker Rule has been "informed." And I am interested in knowing how the loss as reported, how it has "informed" your view in regard to the Volcker Rule, and in particular, what do you think needs to occur in regard to Dodd-Frank now that you have become informed?

Mr. CURRY. Since I believe I used that term, I will be the first to go. I think by "informed" I mean that our experience with the level of risk management that was present at the CIO's office that was engaged in activity that, arguably, may fall under Dodd-Frank's Volcker Rule provision in the proprietary trading and possibly the risk mitigation hedging exception. It really is, I think, illustrating in terms of the types and kinds of oversight structures and mechanisms that would be needed under that particular provision.

Senator MORAN. Has anyone else become informed?

Mr. TARULLO. I did not use the term, Senator, but I will answer you anyway. It seems to me what someone will do—we need people to run through this—is to say, OK, you have got a situation in which the firm has publicly said they did not think this was a well-managed risk, it was supposed to be a hedge. So somebody should align the rule with the practice and say if the rule had been in effect, would it have precipitated the kinds of risk management, identification of strategy, and documentation that would have been adequate to being the attention of both the firm and the supervisors to a potentially risky strategy.

As I sit here today, I think that is the case, but I would certainly want someone to go through it more carefully.

Senator MORAN. Mr. Chairman, thank you. I would like to associate—at least compliment my colleague from Pennsylvania, Mr. Toomey, on what I thought was a very logical presentation and, in my view, enlightening. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman, and thank you for holding this hearing.

This was not something I was going to talk about, but I appreciate Senator Moran's comments. I would say that I think all of us believe we want to have as efficient a capital market as possible, a profitable capital market, a secure capital market in this country. But I just want to be clear because I sat here 3 years ago and heard the testimony on the credit default swaps that brought down these large financial institutions and put my family and your families through enormous economic turmoil, that it was very clear to me that the testimony we were hearing was that no one was watching that, that no one had a view of the systemic risk that was produced by those transactions, and to think of those as merely bad loans rather than securitized instruments that nobody was watching I think is not an accurate reflection—and this is not anything you said, Senator, but this is not an accurate reflection of the history of what we heard. I am not for any more regulation than is needed, and I share some of the skepticism on the other side about the ability of the regulators to keep up with what is going on in the capital markets, which raises the importance of capital as you described earlier. But I do want people to remember why we are here to begin with and the gaps that we saw in the regulation that had a profound effect on this economy, on the people that I represent.

So having said that for the record, I want to go back to actually the Ranking Member's very first question, or one of them, which was what was the nature of this transaction. Was it proprietary or was it a hedge? And we know through the testimony today that we do not have an answer to that yet. But here is how I would like to ask that question to Mr. Curry and to Mr. Tarullo, which is this:

Explain to us what that examination is going to look like. What will you consider as you think about defining that? Because I think you are quite right, we can learn something from that. Those of us that are cautious about those definitions would like to know what you are actually going to be looking at.

Mr. CURRY. At the OCC, we have a two-pronged approach to this particular issue. Number one, we want to fully understand the nature of the hedge or trading activity at issue. We also want to get an assessment and a full understanding of how the bank intends to reduce its exposure or de-risk from that position.

Part of that process and as part of our secondary prong, which is to——

Senator BENNET. Can I just—I am sorry to interrupt, but the first step is to determine the nature, but the second step is to determine the risk—the attention to risk in the institution. Is that second determination dependent on the nature of the transaction?

Mr. CURRY. No, the first prong is really to assess what is the financial risk to the institution, and that is really a priority, particularly immediately after this issue surfaced. But we are also looking

at it almost from a postmortem standpoint of what happened, where were the deficiencies, what needs to be corrected, are there additional risk management gaps elsewhere in the organization, and is there an opportunity to learn from this experience in terms of the risk management practices at the other large institutions that we supervise. That is the general scope of our review.

Senator BENNET. Governor, do you have anything you would like to add? Then I have got one question for you.

Mr. TARULLO. Then I think, Senator, you should—why don't you go ahead and give me the question, because I think——

Senator BENNET. I was going to shift to your—well, you made an observation earlier that I thought I heard you say the low likelihood of a tail experience with Europe, and I just wanted—I want to know why you think that is a low likelihood or if I misunderstood what you——

Mr. TARULLO. No, I was referring more generally, Senator, to the fact that, at least in my observation, the modeling that financial firms do, VaR modeling and associated kinds of modeling, to try to understand what their risk of losses are from any number of contingencies tend not to be as oriented toward tail risks, which means events that, while appearing at that moment to be low probability, would, if they transpired, have enormous loss. I was not commenting——

Senator BENNET. So in that spirit, since we are about to—I do not know, Secretary Wolin, if you would like to talk about this at all. How do you view that risk right now as you are sitting here? I understand that the balance sheets here are in better shape than the balance sheets are in Europe, but the risk of collapse there?

Mr. WOLIN. Well, I think, Senator, a couple things. First of all, I think that European leaders appear to be moving with a heightened sense of urgency. I think the run-up to the G20 meetings is Los Cabos will be an important opportunity for them to make further progress with respect to their banks, the capitalization of their banks and the restructuring of their banks. And as you have seen, they are considering those things really now on a European-wide basis.

The Europeans have the will and they certainly have the capacity to keep this thing together. The President, the Secretary of the Treasury, and others throughout the Administration are very much engaged; I think that we will see as developments move forward. I think it is not useful for me to hazard a guess, but I think what is clear is they have the will, they have the capacity, and I think they understand more than ever before the urgency to start taking the actions that are consistent with avoiding some of the most unpleasant outcomes.

Senator BENNET. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman. Thank you all for joining us.

I am glad to hear my colleagues on both sides of the aisle talk about the importance of capital requirements. They seemed less convinced of that during the drawing up of Dodd-Frank, but if there are changes to Dodd-Frank, that may be somewhere where

we want to look, and especially the discussion from Mr. Toomey and Mr. Moran on the importance of higher capital requirements.

Mr. Curry, my questions will be to you, if I could. I have sent you a number of written questions. I look forward to your prompt and substantive response, and I would appreciate those answers prior to Mr. Dimon appearing in front of this Committee next week. I really hope you are able to do that.

Last June, about a year, my Subcommittee held a hearing on bank examination and supervision at which the OCC testified. You were not here then, of course. I appreciate your taking the responsibility of this job. It is difficult in these circumstances, especially with the reputation of the history of your agency.

I want to share some of that testimony, and I appreciate—I would insist on brief answers because I have several questions and limited time, as you know how this works. And I particularly would appreciate a yes or no response.

David Wilson, OCC's head of credit and risk, testified, "Given the importance in the role that these large institutions play in the overall financial stability of the United States, we have instructed our examiners that these organizations should not operate with anything less than strong risk management and audit functions. Anything less will no longer be sufficient."

Jamie Dimon himself said JPMorgan's trades were flawed and complex and poorly reviewed, poorly executed, and poorly monitored. I would like a yes or no on this question. Did OCC meet the standard prior to your being there, did it meet the standard that it set for itself in this case?

Mr. CURRY. Before I answer that, I do want to acknowledge that we are working on responses to your written letter and will endeavor to get it to you prior to Mr. Dimon's testimony.

Senator BROWN. Thank you for that.

Mr. CURRY. In this answer, I think the answer is no, not in the particular case of the CIO's office, it does not appear that they met the heightened expectation——

Senator BROWN. Thank you for that answer.

Mr. CURRY. ——to meet demand.

Senator BROWN. Mr. Wilson also said at that hearing that every report of examination is reviewed and approved by the responsible ADC or Deputy Controller before it is finalized. Both units have formal quality assurance processes that assess the effectiveness of our supervision and compliance with OCC policies. Again, I know you were not there, but did they just not—did the Deputy Comptroller and the Assistant Deputy Comptroller simply not know about them?

Mr. CURRY. This is part of the inquiry that we are conducting to determine how we can improve our processes.

Senator BROWN. Thank you for that. Your written testimony suggests that the examiners and the supervisors were unaware of the activities occurring at JPMorgan's Chief Investment Office until April of this year. And what is intriguing about that is this: This office was making $360 billion in trades. This is larger than the assets of 7,299 banks in the United States. If there were a standalone bank, it would be the eighth largest bank in the United States. It was making a trade that you say is the biggest, most

complex trade in the entire banking system, and the question then is this: Should the eighth largest bank in the Nation be allowed to make the biggest, most complex trade—your words—in the entire banking system without the OCC's knowledge?

Mr. CURRY. We would expect to be aware of significant risks, to have the bank identify them and for us to have adequate reporting about those risks.

I just want to clarify that the CIO's office invests a pool of approximately $350 billion, but that this particular area was a discrete portion of it, and that may be part of the reason why it was not identified as quickly as we would like.

Senator BROWN. It still should have been identified, and that is an issue of the structure of OCC—again, under different management than when you were there—than you are there now, of course.

This is not about—I hear that—and this will be a discussion for next week, but I hear about the $2 billion or $4 billion lost at the Chief Investment Office. That is serious, but it is obviously more than that. JPMorgan took a $25 billion hit to their stock. That is 401(k)s, that is pension funds, that is a loss of wealth to a large number of people. We went through that in multiples higher than that, of course, 2 and 3 years ago. And they are a signal that the market believes that this event demonstrates bigger problems in the management and oversight at JPMorgan.

This begs the issue that these trillion dollar—$2 trillion in that case—mega banks are not just too big to fail; they are too big to manage and they are too big to regulate. But the OCC's position has been that, "They do not subscribe to the view that big in and of itself is bad."

As long as OCC continues to insist that big, complex banks are actually essential to our economy, they are responsible for their inability to properly examine and supervise these mega, mega banks.

I appreciate you are working to improve your oversight, but I heard the same promise last year—again, under different management. For the OCC to, in your words, "determine what in retrospect the OCC could have done differently, you need to"—and I know you want to look forward. That is your job. But you need to identify what mistakes were made, by whom those mistakes were made, and if JPMorgan can hold its senior executives accountable, which they appear, at least in part, to be doing, we should expect nothing less than you, Mr. Curry, and the people who work for you, whether they are the people that are there now or the people whom you replace them with.

Thank you.

Chairman JOHNSON. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman, and I thank the witnesses.

One of the obvious issues raised by JPMorgan trading losses is the role of risk management at the banks, especially large banks. As some of you know, I fought to have included in Dodd-Frank a provision, Section 165(h), requiring all banks with over $10 billion in assets and all nonbank financial firms supervised by the Fed to have a separate risk committee that includes at least one "risk

management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms."

Now, Mr. Curry, in your testimony, you say you "will require the bank to adhere to the highest risk management standards." In your assessment, did the JPMorgan risk policy committee have sufficient expertise in risk management to carry out its duties? Also, it has been reported JPMorgan is changing the composition of its risk policy committee. Can you provide the Committee with an update on those changes and discuss whether you think the new Members of the Committee have sufficient expertise?

Mr. CURRY. Thank you, Senator. The introduction of the risk committees through Dodd-Frank is a welcome improvement to the overall corporate governance of financial institutions, particularly large institutions, and we view the role of the board in terms of corporate governance as a mitigant to excessive risk as being a critical feature of sound risk management.

In this particular case, there appears to have been a breakdown at the CIO level's risk management architecture and system and controls. That is a matter of significant concern to us at the OCC, and it is also one in which we have endeavored to make sure is not endemic throughout the entire organization. We hope that the reconstituted risk committee members of the board will be experts in——

Senator SCHUMER. Have you reviewed the risk committees of other banks with over $10 billion to determine whether they have the necessary expertise? And that is for Mr. Tarullo as well.

Mr. TARULLO. Senator, one of the virtues of the provision that you referred to is that, as one of the enhanced prudential standards, it will now precipitate what we call a horizontal comparison and review, meaning that for those largest institutions, our large institution supervision committee will look at each and compare them. And I think it is that process which is actually going to give the individual supervisory teams on the ground more guidance and more insight as to what they should expect.

Senator SCHUMER. Right. And I suppose there is some difference. There are some banks that are over $10 billion that are pretty plain vanilla banks and other banks over $10 billion——

Mr. TARULLO. That is absolutely correct.

Senator SCHUMER. ——that are doing all these fancy, sometimes unfathomable things.

Mr. TARULLO. That is correct.

Senator SCHUMER. You did not correct the word "unfathomable."

Mr. Curry, are you reviewing other banks as well?

Mr. CURRY. That is a critical component of our assessment of corporate governance and the overall risk management policies.

Senator SCHUMER. So you are.

Mr. CURRY. Yes.

Senator SCHUMER. OK. Second question, and this is for you, Mr. Curry. JPMorgan's credit derivative trades were made by a group that is part of the U.S. bank, but apparently all booked in London. Do you as the U.S. regulator have full access to the information you need about trading activity conducted in London if it is carried out by a U.S. bank? And what more needs to be done to improve

coordination with international regulators to prevent these kinds of cross-border losses?

Mr. CURRY. The London operations at JPMorgan are conducted through a branch of the national bank. So in terms of jurisdiction, we have clear jurisdiction over the activities of that branch.

In the case of JPMorgan Chase, those activities are managed on a global basis through the New York office where we have the majority of our core staff.

Senator SCHUMER. OK, good. All right. Third question, and it is about early warning systems. Traders at several hedge funds, we have read in the newspapers, have been able to spot the JPMorgan trade through its irregular impact on the market for credit derivatives. So it begs the obvious question. Why didn't the regulators know? Obviously, regulators cannot micromanage every trading position at every bank. That would be impossible for you to do. But is it possible to build an early warning system that could warn us if, say, a single company accumulates unusually large positions in any single product, as it appears with the JPMorgan case? Last month, I asked the SEC and CFTC Chairmen if it would be possible. They both said that with the new information to be reported under Dodd-Frank, we will be able to set up early warning systems that could identify risky positions before they blow up.

So my question goes to both you, Mr. Tarullo, and any others who care to add their opinions. What can and should regulators do to improve their ability to identify potentially risky trading activity ahead of time. And I realize foresight is a gift and it is not easy, but at least when you are getting above a certain level of money, a little bell could go off, and maybe it is a perfectly plain vanilla safe trade and maybe it is not, but it would not ask you to get involved in every single thing that the banks are doing.

I will first go to Mr. Tarullo, Mr. Curry, and anybody else.

Mr. TARULLO. So, first, obviously, is the risk management of the firm as overseen by the supervisors, which should include and generally does include things like position limits, and that should be a first early warning.

Second, Senator, we do already within our supervisory process look at market indicators, including aggregated market information, to try to identify trends that might be relevant to the particular institution. But our ability to do that obviously depends on the relative granularity or specificity of the information, and in this case, for example, I believe there were products which, although they could be a big part of a market, JPMorgan could be a big part of a market, for the overall financial markets are still relatively small. So unless there is reporting on more specific products like that, our normal look at market information would not have revealed this. So it has to come internally.

Senator SCHUMER. And what about after Dodd-Frank is fully implemented where you will get more significant information?

Mr. TARULLO. Yes, there I think what is most important is when a firm is taking a hedging position, it will be required to specify what its strategy is and what its risk management and what the monitoring of that strategy will be, and the supervisors will have ex ante, or beforehand, access to that information rather than have to rely on us going in afterwards.

Senator SCHUMER. OK. So you think it will improve with Dodd-Frank being implemented?

Mr. TARULLO. I think it will improve.

Senator SCHUMER. Mr. Curry.

Mr. CURRY. Yes, as Governor Tarullo mentioned, this was a highly complex, illiquid, and concentrated investment. It would have been very helpful if there were market or other data available that would highlight this concentration to us as a regulator. So to the extent that the Dodd-Frank Act does provide that or that there is other readily market information that we could utilize, it would be very helpful.

Senator SCHUMER. And the fact that they have to report and justify this, does that tend to be prophylactic, or do they still have to do that within the bank anyway so it does not make a difference if they send the report to you?

Mr. CURRY. The reporting would be very helpful, and that is one of the issues here, whether there was adequacy of reporting and whether that reporting was available to the OCC and the Federal Reserve examiners.

Senator SCHUMER. My time has expired. Anyone else care to comment?

[No response.]

Senator SCHUMER. OK. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you.

Senator Shelby has an additional question.

Senator SHELBY. Thank you.

Governor Tarullo, in your testimony you state, and I will quote—and I want to be like Senator Toomey and agree with you on this. You said, "Recent events serve to remind us that the presence of substantial amounts of high-quality capital is the best way to ensure that significant losses at individual firms"—meaning financial institutions—"are borne by their shareholders and not depositors or taxpayers."

What percentage of capital under Basel III will large banks likely hold under the new enhanced capital standards? And will this amount, in your judgment, be sufficient? I think it is a given here that there is no substitute for capital. You can regulate everything in the world, but if they have inadequate capital, you know what is going to happen sooner or later.

Mr. TARULLO. Senator, as you know, because you quoted from me, I do believe in the centrality of capital. I do not think it is the only way——

Senator SHELBY. Oh, no.

Mr. TARULLO. But it is a central way.

Senator SHELBY. But it is number one, is it not?

Mr. TARULLO. In my judgment, yes.

The Basel requirements are for a 7-percent common equity ratio, which is a substantial increase over the pre-crisis level.

Senator SHELBY. Tell the public what you mean by common equity, 7 percent.

Mr. TARULLO. Traditionally, measures of capital, the measure of capital, so-called Tier 1 capital, which could include common equity, which people generally think of as shareholdings, shareholder earnings, retained earnings, and what they have put into the com-

pany; but it also included some other kinds of hybrid instruments, the loss absorption capacity of which for an ongoing firm is not as strong as for common equity. So basically pre-crisis, if you went down, dug down into the requirements, it was only really a 2-percent common equity ratio requirement, meaning you had to have common equity which was at least 2 percent of your risk-weighted assets; Basel III takes that up to 7 percent for banks generally. And then as you referenced, with respect to very large institutions, there will be, once we have implemented our additional authority, a surcharge, which at present we think will be between another 1 percentage point and 2.5 percentage points.

Now, is that enough? Well, as I have said publicly before, my preference would have been to have both somewhat higher, but these were negotiated internationally. We did set them with an eye to those other regulatory tools that you talked about. So there are some restraints on activities. There is some market discipline. There is some supervisory capacity. And it is always going to be a balance as to how much capital is enough given what other tools you have.

Senator SHELBY. Do you believe that our banks are overall in much better shape than they were 3 years ago?

Mr. TARULLO. Yes, Senator.

Senator SHELBY. Do you agree with that, Mr. Secretary?

Mr. WOLIN. I do, Senator. Yes, absolutely.

Senator SHELBY. Mr. Curry.

Mr. CURRY. Yes, definitely, with respect to national banks and Federal thrifts.

Mr. GRUENBERG. Yes, Senator.

Senator SHELBY. OK. And do you believe that a lot of it is because of required capital and the buildup of capital—not everything, but do you believe that that is central to that? Governor Tarullo.

Mr. TARULLO. I do believe it is central, but I do also think that there has been a good bit of de-risking during that period.

Senator SHELBY. Is there some risk to the economy if people try to take most risk out of the banking system? In other words, you make a loan, that is a risk. You hedge something, that is a risk. Or you are trying to manage risk. You cannot take real risk out of the financial system, can you? Mr. Secretary.

Mr. WOLIN. No, you cannot, Senator.

Senator SHELBY. We would not want to, would we?

Mr. WOLIN. You would not want to.

Senator SHELBY. Governor.

Mr. TARULLO. That is correct. It is always a question of, one, properly understood and managed risk; and, two, of course, a capital buffer when things happen that you do not anticipate.

Senator SHELBY. Any comment?

Mr. CURRY. I would agree with the Governor.

Mr. GRUENBERG. I agree also, Senator.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you all for your testimony and for being here with us today.

Now with the continued threat from Europe and the recent reminder that risks in the financial system must be appropriately

managed, we must remain vigilant and complete the implementation of Wall Street reform to enhance financial stability and reduce systemic risk.

This hearing is adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN TIM JOHNSON

I call this hearing to order. This hearing is part of the Committee's continued oversight of the implementation of the Wall Street Reform Act, and it is also an opportunity to discuss with our bank regulators the implications of the massive trading loss recently announced by JPMorgan Chase, one of our Nation's largest banks. When a bank with JPMorgan's solid reputation announces that it lost billions of dollars on a large trade reportedly designed to reduce the firm's risks, it reminds us that no financial institution is immune from bad judgment.

While the JPMorgan trading loss does not appear to have caused systemic problems, it is a clear reminder that Wall Street continues to need better risk management, vigorous oversight and, if the rules are broken, unyielding enforcement. To repeal or weaken Wall Street Reform, and defund the cops enforcing it, would take us back to the days before the financial crisis of 2008.

Wall Street Reform was a response to the crisis caused by a lack of consumer protection, reckless behavior in the financial sector, and regulators who failed to take action in time. We now have an agency solely focused on consumer protection, tough new rules to end negligent and reckless practices by some on Wall Street, and regulators armed with new powers to ensure the safety and soundness of the banks they supervise.

The regulators are also in the process of enhancing the standards for our Nation's largest banks, through increased capital requirements and more judicious liquidity and leverage standards.

Wall Street Reform also requires regulators to sharpen their focus on the largest and riskiest financial institutions. All the regulators joining us today are members of the Financial Stability Oversight Council, a body created to monitor risks facing our financial system. Most here are also all working on the "Volcker Rule" to prohibit proprietary trading with Government-insured deposits, and the FDIC continues to work diligently to implement the "living wills" requirements and establish the Orderly Liquidation Authority for global, large, complex financial institutions.

Similarly, while there is a need for strong regulation of all financial institutions, Wall Street Reform recognizes that small community banks should not be treated the same as the largest banks. Because large, complex banks take on the most risk and pose the greatest threat to our economic stability, they should be required to pay their fair share into the Deposit Insurance Fund. Likewise, the small banks that did not cause the crisis should not have to pay for the risks taken on by their larger competitors—and their assessments have been lowered accordingly.

A one-size-fits-all approach is not appropriate and many parties have raised concerns about challenges faced by small community banks. I hope to hear from our witnesses today about the steps they are taking with regard to small banks.

Some have claimed that the Wall Street Reform Act was not the right set of solutions to the crisis, and that it asks our regulators to micromanage the activities of the firms they regulate. I disagree. To restore confidence in our financial system after the crisis, we need more, not less, scrutiny of Wall Street's activities. The Wall Street Reform Act has built a stronger oversight framework that closes regulatory gaps, enhances financial stability, and better protects consumers, investors, and taxpayers.

And so despite the repeated calls to deregulate and to defund by those who ignore the costly lessons of the financial crisis, completing the implementation of the Wall Street Reform Act must be, and remains, a top priority for this Committee.

In that vein, I look forward to hearing from the witnesses here today about the progress they have made to complete implementation of Wall Street Reform, as well as the actions they have taken regarding the JPMorgan trading loss, and their thoughts on potential implications of the loss for supervision and Wall Street Reform rulemakings going forward.

I also want to thank Ranking Member Shelby and my colleagues here on the Banking Committee for all their input and cooperation over the past several months. At a time when most of America thinks that Congress is in a gridlock, the Committee has been very busy getting things done on the Senate floor. The bipartisan Export-Import Bank Reauthorization passed with broad support and was signed into law by the President last week. We passed in the Senate this Committee's bipartisan Iran Sanctions bill. Both nominees for the Federal Reserve Board of Governors received floor votes, and we helped to secure the passage of their confirmation. We passed the bipartisan Transportation bill in the Senate, and the Transportation Conference Committee meetings are currently ongoing with the House. And we passed a 60-day extension of the National Flood Insurance Program, and we have a commitment from the Senate's leadership to bring the Banking Committee's bipartisan NFIP reauthorization bill to the floor in the coming weeks.

In addition, there is another important legislative matter facing this Committee—helping responsible homeowners refinance into lower interest rates at no cost to the taxpayers. We have already had several full Committee and Subcommittee hearings on refinancing proposals. I would like to take a bipartisan approach similar to the other Committee-passed bills of this Congress where we work together on a bipartisan vehicle with amendments limited to those related to the underlying bill. I am hopeful that my colleagues will agree to move forward in this manner as well so we can help responsible homeowners and help the housing market rebound.

PREPARED STATEMENT OF NEAL S. WOLIN

DEPUTY SECRETARY, DEPARTMENT OF THE TREASURY

JUNE 6, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to appear here today to discuss progress implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

The Dodd-Frank Act represents the most significant set of financial reforms since the Great Depression. Its full implementation will help protect Americans from the excessive risk, fragmented oversight, and poor consumer protections that played such leading roles in bringing about the recent financial crisis.

That crisis, and the recession that accompanied it, cost nearly 9 million jobs, erased a quarter of families' household wealth, and brought GDP growth to a low of nearly negative 9 percent.

Today, our economy has improved substantially, although more work remains ahead. More than 4.3 million private sector jobs have been created over the past 27 months and, since mid-2009, our economy has grown at an average annual rate of 2.4 percent.

As part of our broader efforts to strengthen the economy, Treasury is focused on fulfilling its role in implementing the Dodd-Frank Act to build a more efficient, transparent, and stable financial system—one that contributes to our country's economic strength, instead of putting it at risk.

The Dodd-Frank Act's reforms address key failures in our financial system that precipitated and prolonged the financial crisis. The Act's core elements include:

Tougher constraints on excessive risk-taking and leverage across the financial system. To lower the risk of failure of large financial institutions and reduce damage to the broader economy in the event a large financial institution does fail, the Dodd-Frank Act provides authority for regulators to impose tougher safeguards against risks that could threaten the stability of the financial system and the broader economy.

The Federal Reserve has proposed new standards to require banks to hold greater capital against risk and fund themselves more conservatively. New rules restricting proprietary trading under the Volcker Rule and limits to the size of financial institutions relative to the total financial system have been proposed or will be proposed in the coming months. Safeguards against excessive risk-taking and leverage will not only apply to the biggest banks, but also designated nonbank financial companies. Importantly, the bulk of these requirements do not apply to small and community banks, and help level the playing field for these smaller participants by helping eliminate distortions that previously favored the biggest banks that held the most risk.

The Dodd-Frank Act also established the Financial Stability Oversight Council (the Council) to coordinate agencies' efforts to monitor risks and emerging threats to U.S. financial stability, and the Office of Financial Research (OFR) to collect and standardize financial data, perform essential research, and develop new tools for measuring and monitoring risk in the financial system.

Orderly liquidation authority. The Dodd-Frank Act created a new orderly liquidation authority to resolve a failed or failing financial firm if its failure would have serious adverse effects on the financial stability of the United States. The statute makes clear that taxpayers will not be put at risk in the event a large financial firm fails. Investors and management, not taxpayers, will be responsible for the cost of the failure.

The FDIC has completed most of the rules necessary to implement the orderly liquidation authority, and is engaging in planning exercises with Treasury and other regulators to coordinate how it would work in practice. This summer, the largest bank holding companies will submit the first set of "living wills" to regulators and

the Council. These documents will lay out plans for winding down a firm if it faces failure.

Comprehensive oversight of derivatives. The Dodd-Frank Act created a new regulatory framework for over-the-counter derivatives markets to increase oversight, transparency, and stability in this previously unregulated area of the financial system.

Regulators have proposed almost all the necessary rules to implement comprehensive oversight of the derivatives markets, and we expect most to be finalized this year. We are already seeing signs of standardized derivatives moving to central clearing, and substantial work is being done to build out new financial infrastructure to move trades into clearing and onto electronic trading platforms.

Stronger consumer financial protection. The Dodd-Frank Act created the Consumer Financial Protection Bureau (CFPB) to consolidate consumer financial protection responsibilities that had been fragmented across several Federal regulators into a single institution dedicated solely to that purpose. The CFPB's mission is to help ensure consumers have the information they need to make financial decisions appropriate for them, enforce Federal consumer financial laws, and restrict unfair, deceptive, or abusive acts and practices.

The CFPB is currently working to improve clarity and choice in consumer financial products through the Know Before You Owe project, which aims to simplify mortgage forms, credit card disclosures, and student financial aid offers. The CFPB is also focused on helping improve consumer financial protections for groups like servicemembers and older Americans, as well as bringing previously unregulated consumer financial institutions, like payday lenders, credit reporting bureaus, and private mortgage originators, under Federal supervision for the first time. Earlier this year, the CFPB commenced its supervision of debt collectors and credit reporting agencies.

Transparency and market integrity. The Dodd-Frank Act included a number of measures that increase disclosure and transparency of financial markets, including new reporting rules for hedge funds, trade repositories to collect information on derivatives markets, and improved disclosures on asset-backed securities.

This summer, the largest hedge funds and private equity funds will be required to report important information about their investments and borrowing for the first time, helping regulators understand exposures at these significant investment vehicles. New swaps data repositories are being created that will provide regulators and market participants with a stronger understanding of the scale and nature of exposures within previously opaque derivatives markets.

Treasury's core responsibilities in implementing the Dodd-Frank Act include the Secretary's role as Chairperson of the Council, standing up the Office of Financial Research and Federal Insurance Office, and coordinating the rulemaking processes for risk retention for asset-backed securities and the Volcker Rule.

The Financial Stability Oversight Council

The Dodd-Frank Act created the Financial Stability Oversight Council to identify risks to the financial stability of the United States, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system.

The Council is actively engaged in these activities and has begun to institutionalize its role. To date, the Council has held 17 principals meetings, four since I last testified in December. In recent months, the Council's principals have come together to share information on a range of important financial developments as the Council, its members, and staff have actively engaged in monitoring the situation in Europe, in housing markets, the interaction of the economy and energy markets, and the lessons to be drawn from recent errors in risk management at several major financial institutions, including the failure of MF Global and trading losses at JPMorgan Chase. In addition to regular engagement at the principals level, the Council has active staff discussions through twice monthly deputies level meetings and ongoing staff work on individual committee and project workstreams.

The Council expects to release its second annual report on financial market and regulatory developments and potential emerging threats to our financial system in July. In addition to providing new recommendations, the report will include an update on the progress made on last year's recommendations, which focused on enhancing the integrity, efficiency, competitiveness, and stability of U.S. financial markets, promoting market discipline, and maintaining investor confidence.

One of the duties of the Council is to facilitate information-sharing and coordination among its members regarding rulemaking, examinations, reporting requirements, and enforcement actions. Through meetings among principals, deputies, and staff, the Council has served as an important forum for increasing coordination among the member agencies. Some argue that the Council should be able to ensure

particular outcomes in independent agencies' rules, or perfect harmony between rules with disparate statutory bases. While the Council serves a very important role in bringing regulators together, the Dodd-Frank Act did not eliminate the independence of regulators to write rules within their statutory mandates.

Nonetheless, the Dodd-Frank Act implementation process has brought about unprecedented cooperation among agencies in writing new rules for our financial system. As Chair of the Council, Treasury continues to make it a top priority that the work of the regulators is well-coordinated.

The Treasury Secretary, as Chairperson of the Council, is coordinating the rulemaking required for the Dodd-Frank Act's risk retention requirements, which are designed to improve the alignment of interests between originators of risk and securitizers of, and investors in, asset-backed securities. After the proposed rule was released, the rule writers received over 13,000 comment letters, and they are continuing to review feedback as they work towards a final rule.

The Council has also made progress on two of its direct responsibilities under the Dodd-Frank Act: designating financial market utilities (FMUs) and nonbank financial companies for enhanced prudential standards and supervision.

In July 2011, the Council finalized a rule setting the process and criteria for designating FMUs and, in August, began working to identify FMUs for consideration in accordance with the statue and the rule. In January 2012, an initial set of FMUs were notified that they would be under consideration for designation. In May, the Council unanimously voted to propose the designation of an initial set of FMUs as systemically important. This vote is not a final determination, and FMUs may request a hearing before the Council to contest a proposed designation. The Council expects to make final determinations on an initial set of FMU designations as early as this summer.

In April 2012, the Council issued a final rule and interpretive guidance establishing quantitative and qualitative criteria and procedures for designations of nonbank financial companies. The Council has begun work to apply the process described in the guidance. The Council recognizes that the designation of nonbank financial companies is an important part of the Dodd-Frank Act's implementation and intends to proceed with due care as expeditiously as possible.

The Dodd-Frank Act also provides for limits on the growth and concentration of our largest financial institutions. The Council has released a study and recommendations on the effective implementation of these limitations, and the Federal Reserve is expected to propose a rule to implement concentration limits later this year.

The Office of Financial Research

The Dodd-Frank Act established the Office of Financial Research to collect and standardize financial data, perform essential research, and develop new tools for measuring and monitoring risk in the financial system.

In December 2011, President Obama nominated Richard Berner to be the OFR's first Director. I appreciate this Committee's support of Mr. Berner's nomination. Confirmation by the full Senate is important to ensure the OFR can fulfill its critical role.

A key component of the OFR's mission is supporting the Council and its member agencies by analyzing financial data to monitor risk within the financial system. Currently, the OFR is working on a number of projects with the Council, including providing analysis related to the Council's evaluation of nonbank financial companies for potential designation for Federal Reserve supervision and enhanced prudential standards; providing data and analysis in support of the Council's second annual report on financial market and regulatory developments and potential emerging threats to our financial system; and, in collaboration with Council member agencies, developing metrics and indicators related to financial stability.

To avoid duplicating existing Government collection efforts or imposing unnecessary burdens on financial institutions, the OFR is focused on ensuring it relies on data already collected by regulatory agencies whenever possible. The OFR is working with regulators to catalogue the data they already collect, along with exploring ways it could promote stronger data sharing for the regulatory community to generate efficiencies and improved interagency cooperation.

As part of its mission, the OFR is also promoting standards to improve the quality and scope of financial data, which in turn should help regulators and market participants mitigate risks to the financial system and provide firms with important efficiencies and cost-savings. One ongoing priority is establishing a Legal Entity Identifier (LEI), or unique, global standard for identifying parties to financial transactions, to improve data quality and consistency. The OFR is playing a lead role in the international process coordinated by the Financial Stability Board (FSB) to de-

velop an LEI. Just last week, the FSB endorsed recommendations the OFR developed in conjunction with its international counterparts to establish a global LEI system. This recognition allows market participants to begin preparing for the implementation of the global LEI next year.

A more comprehensive understanding of the largest and most complex financial firms' exposures is critical to identifying risks to the financial system and mitigating future crises. However, some have expressed concerns about the OFR—involving its accountability, access to personal financial information, and ability to secure sensitive data—that are unfounded.

First, Congress has oversight authority over the OFR, and the statute requires the Director to testify regularly before Congress. Consistent with requirements under the Dodd-Frank Act, the OFR will provide the Congress with its first Annual Report on its activities this summer and a second report, on the Office's human resources practices, later this year. In addition, the Dodd-Frank Act provides authority for Treasury's Inspector General, the Government Accountability Office, and the Council of Inspectors General on Financial Oversight to oversee the activities of the OFR.

Second, regarding data collection, the Dodd-Frank Act does not contemplate and the OFR will not collect personal financial information from consumers. The OFR, like other banking regulators, only has the authority to collect information from financial institutions, not individual citizens. The OFR will only utilize data required to fulfill its mission—assessing threats to stability across the financial system.

Lastly, data security is the highest priority for the OFR. As an office of the Department of the Treasury, the OFR utilizes Treasury's sophisticated security systems to protect sensitive data. The OFR is also implementing additional controls for OFR-specific systems, including a secure data enclave within Treasury's IT infrastructure. Access to confidential information will only be granted to personnel that require it to perform specific functions, and the OFR will regularly monitor and verify its use to protect against unauthorized access. In addition, the OFR is working in collaboration with other Council members to develop a mapping among data classification structures and tools to support secure collaboration and data sharing. Such tools include a data transmission protocol currently used by other Council members that will enable interagency data exchange and a secure collaboration tool for sharing documents.

The Federal Insurance Office

The Dodd-Frank Act created the Federal Insurance Office to monitor all aspects of the insurance industry, identify issues or gaps in regulation that could contribute to a systemic crisis in the insurance industry or financial system, monitor the accessibility and affordability of nonhealth insurance products to traditionally underserved communities, coordinate and develop Federal policy on prudential aspects of international insurance matters, and contribute expertise to the Council.

As a member of the Council, FIO, in addition to two additional Council members that focus on insurance, has been actively involved in the rulemaking establishing the process for the designation of nonbank financial companies. FIO will be engaged in the review of nonbank financial companies as this process moves forward.

Until the establishment of FIO, the United States was not represented by a single, unified Federal voice in the development of international insurance supervisory standards. FIO is providing important leadership in developing international insurance policy. Recently, FIO assumed a seat on the executive committee of the International Association of Insurance Supervisors (IAIS). The IAIS, in cooperation with the Financial Stability Board (FSB), is developing the methodology and indicators to identify global systemically important insurers, and FIO is actively engaged in that process. Additionally, FIO established and has provided necessary leadership in the EU–U.S. insurance dialogue regarding such matters as group supervision, capital requirements, reinsurance, and financial reporting. FIO also participated in the recent U.S.–China Strategic and Economic Dialogue in Beijing. Importantly, FIO has and will continue to work closely and consult with State insurance regulators and other Federal agencies in its work.

Priorities Ahead

Under the Dodd-Frank Act, Treasury is charged with coordinating the implementation of the Volcker Rule. Treasury is actively engaged with the independent regulatory agencies in their work to finalize the Volcker Rule and make sure it is implemented effectively to prohibit proprietary trading activities and limit investments in and sponsorship of hedge funds and private equity funds.

The five Volcker Rule rulemaking agencies released substantially identical proposed rules, which reflect the commitment of Treasury and the regulators to a co-

ordinated approach. The comment periods for all five rulemaking agencies are now complete, and we are reviewing and analyzing over 18,000 public comment letters. Treasury is hosting and actively participates in weekly interagency meetings to review those comments, and remains committed to fulfilling our coordination role and working with the rulemaking agencies to achieve a strong and consistent final rule.

Regulators are still in the process of conducting their evaluation of what happened with respect to recent losses at JPMorgan Chase, and why. The lessons learned from the recent failures in risk management at JPMorgan are an important input into the ongoing efforts to design strong safeguards and reforms, including, of course, those in the Volcker Rule.

The Volcker Rule, as reflected in the statutory language enacted as part of the Dodd-Frank Act and in the proposed rule, explicitly exempts from the prohibition on proprietary trading the ability of firms to engage in "risk-mitigating hedging activities in connection with and related to individual or aggregated positions—designed to reduce the specific risks to the banking entity." To that end, the final rule should clearly prohibit activity that, even if described as hedging, does not reduce the risks related to specific individual or aggregate positions held by a firm.

The exposures accumulated by JPMorgan, in the words of its executives, resulted in potential losses that exceeded its internal limits and those estimated by its internal risk management systems. This raises concerns that go well beyond the scope of the Volcker Rule. Among other things, regulators should require that banks' senior management and directors put in place effective models to evaluate risk, strengthen reporting structures to ensure risks are assessed independently and at appropriately senior levels, and establish clear accountability for failures in risk management. Regulators should make sure that they have a clear understanding of exposures and that banks and their senior management are held accountable for the thoroughness and reliability of their risk management systems. To further accountability, there should also be appropriate public transparency of risk management systems and internal limits.

Ultimately, the true test of reform is not whether it prevents firms from taking risk or from making mistakes, but whether our financial regulatory system is tough enough and designed well enough to prevent those mistakes from hurting the broader economy or costing taxpayers money. We all have an interest in achieving this outcome.

I emphasize the broader framework of reforms because our ability to protect the economy from financial mistakes in banks depends on the authority and resources we have to enforce tougher capital, leverage, and liquidity requirements on banks and the largest, most complex nonbank financial companies.

It depends on our ability to put in place the full framework of protections in the Dodd-Frank Act on derivatives, from margin requirements and central clearing of standardized derivatives to greater transparency into risks and exposures.

It depends on the resources available to the SEC, the CFTC, the CFPB and the other enforcement authorities to police and deter manipulation, fraud, and abuse.

It depends on our ability to protect taxpayers from future financial failures, in particular our ability to safely unwind a large firm without the broad collateral damage and risk to the taxpayer that we experienced in 2008.

And it depends on making sure that no exception built into the law is allowed to swallow the rule, frustrate the core purpose of the legislation, or otherwise undermine the impact of the tough safeguards we need.

The challenges our economy continues to experience since the financial crisis in 2008 only increase our commitment to make sure we meet our responsibility to the American public to implement lasting financial reform.

Recent events provide an additional reminder that comprehensive reform must continue to move forward. The Administration will continue to resist all efforts to roll back reforms already in place or block progress for those that remain to be implemented. The lessons of the financial crisis should not be left unlearned or forgotten, nor should American workers—or American taxpayers—be left unprotected from the consequences of future financial instability.

I appreciate the opportunity to discuss the priorities and progress associated with our work implementing the Dodd-Frank Act, and the leadership and support of this Committee in those efforts.

Thank you.

PREPARED STATEMENT OF DANIEL K. TARULLO

MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JUNE 6, 2012

Chairman Johnson, Ranking Member Shelby, and other Members of the Committee, thank you for the opportunity to testify on the Federal Reserve's implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

As we approach the second anniversary of the Dodd-Frank Act, implementation of the financial reforms enacted by the Congress remains a formidable task. At the Federal Reserve, staff teams with a wide range of expertise continue to contribute to Dodd-Frank Act projects, many as part of joint rulemaking efforts with other Federal agencies. We have been working to put final Dodd-Frank Act rules in place and to negotiate and implement international reforms compatible with various Dodd-Frank Act provisions; these include enhanced capital requirements for systemically important banks, liquidity requirements, resolution mechanisms, and margining requirements for over-the-counter derivatives.

As we continue rule implementation and the related international initiatives, we are trying to provide as much clarity as possible to financial markets and the public about the post-crisis financial regulatory landscape, and are also taking the time to consider comments and alternatives carefully. In addition, the Federal Reserve continues to work cooperatively with other supervisors to ensure that prudential supervision is conducted in a manner that supports these important reforms.

As a final introductory point, it bears noting that both the Dodd-Frank Act reforms and the international regulatory reforms share an important feature—a strong focus on the largest, most complex, and most interconnected financial firms and the systemic risks posed by those firms. This effort reflects the provenance of both the Dodd-Frank Act and international reform initiatives, which were motivated largely by the failure or near failure of a number of major financial firms and the significant public policy problems created by the market perception that such firms are "too big to fail." As the Federal Reserve implements reforms, we have maintained this core focus on the largest firms by proposing rules that try to mitigate the systemic risks posed by those firms and minimize the burden on smaller entities, particularly community banks. Similarly, we seek to implement reforms in a manner that is faithful to statutory requirements and that maximizes financial stability and other economic benefits at the least cost to credit availability and economic growth.

This morning I will briefly describe the Federal Reserve's progress on several important Dodd-Frank Act rules and recent reforms to the international bank regulatory framework. I will also describe briefly the Federal Reserve's role in supervising and examining the largest financial firms in cooperation with other Federal and State supervisors.

Enhanced Capital Standards

While robust bank capital requirements alone cannot ensure the safety and soundness of our financial system, they are central to good financial regulation precisely because capital is available to absorb all kinds of potential losses—unanticipated as well as anticipated. Indeed, the best way to safeguard against taxpayer-funded bailouts in the future is for our large financial institutions to have capital buffers commensurate with their own risk profiles and the damage that would be done to the financial system if such institutions were to fail. Recent events serve to remind us that the presence of substantial amounts of high-quality capital is the best way to ensure that significant losses at individual firms are borne by their shareholders, and not by depositors or taxpayers. Ensuring the capital adequacy of financial firms requires both improvement of the traditional, firm-based approach to capital regulation and the creation of a more systemic, or macroprudential, component of capital regulation.

With respect to improving the traditional approach to capital regulation, the Federal Reserve's work has principally involved the development of stronger regulatory capital standards in cooperation with other supervisors in the Basel Committee on Banking Supervision. This work includes the so-called Basel 2.5 reforms that strengthened the market-risk capital requirements of Basel II. This work also includes the Basel III reforms, which improve the quality of regulatory capital, increase the quantity of required minimum regulatory capital, require banks to maintain a capital conservation buffer and, for the first time internationally, introduce a minimum leverage ratio. The Federal Reserve and other U.S. banking agencies are moving to finalize regulations to implement Basel 2.5 in the United States and soon will be proposing regulations to implement Basel III.

These significant changes to the international regulatory capital framework have been supplemented by an important element of the Dodd-Frank Act known as the "Collins Amendment." The Collins Amendment provides a safeguard against declines in minimum capital requirements in the Basel II capital regime based on bank internal modeling. The Federal Reserve and other U.S. banking agencies issued final rules to implement this provision in June 2011.

Capital Surcharges for Systemically Important Financial Firms

The recent financial crisis also made clear that the existing international regulatory capital framework was not sufficiently responsive to macroprudential concerns, such as the threat to financial stability posed by systemically important financial institutions. Accordingly, in Basel Committee deliberations, the Federal Reserve advocated for capital surcharges on the world's largest, most interconnected banking organizations based on their global systemic importance. Last year, an international agreement was reached on a framework for such surcharges, to be implemented during the same 2016–2019 transition period for the capital conservation buffers in Basel III. This initiative is consistent with the Federal Reserve's obligation under section 165 of the Dodd-Frank Act to impose more stringent capital standards on systemically important financial institutions, including the requirement that these additional standards be graduated based on the systemic footprint of the institution.

Both the Dodd-Frank Act provision and the Basel framework are motivated by the fact that the failure of a systemically important firm would have dramatically greater negative consequences on the financial system and the economy than the failure of other firms. Stricter capital requirements on systemically important firms should also help offset any funding advantage these firms derive from any remaining perceived status as too-big-to-fail and provide an incentive for such firms to reduce their systemic footprint. The Federal Reserve's aim has been to fashion the enhanced capital requirements of section 165 and work toward an associated international framework in a simultaneous and congruent manner.

Stress Testing and Capital Planning

Recent improvements to the regulatory capital framework have important supervisory complements in the Federal Reserve's development of firm-specific stress testing and capital planning requirements. These supervisory tools serve two related functions. First, they make capital regulation more forward-looking by testing whether firms would have enough capital to remain viable financial intermediaries if they sustained hypothetical losses in asset values and earnings in an adverse macroeconomic scenario. Second, they contribute to the macroprudential dimension of supervision by enabling simultaneous examination of the risks faced by all large financial institutions in a hypothetical adverse economic scenario.

The Dodd-Frank Act creates two forms of stress-testing requirements. These requirements mirror the Supervisory Capital Assessment Program model, a 2009 effort led by the Federal Reserve that helped restore confidence in the viability of the banking system during the financial crisis. First, the act mandates that the Federal Reserve conduct annual stress tests on all bank holding companies with $50 billion or more in assets to determine whether they have the capital needed to absorb losses in hypothetical baseline, adverse, and severely adverse economic conditions. Second, the act requires both these companies and certain other regulated financial firms with assets between $10 billion and $50 billion to conduct internal stress tests. The Federal Reserve must publish a summary of results of the supervisory stress tests and issue regulations requiring firms to publish a summary of the company-run stress tests.

Regular and rigorous stress testing provides regulators with knowledge that can be applied to both microprudential and macroprudential supervision efforts. Disclosure of the general methodology and firm-specific results of our stress testing has additional regulatory benefits. First, the release of certain details about assumptions, methods, and conclusions exposes the supervisory approach to greater external scrutiny and discussion. Such discussions will almost surely help us improve our assumptions and methodology over time. Second, because bank portfolios are difficult to value without a great deal of detailed information, the stress test results should be very useful to investors in and counterparties of the largest banking firms. Further, I believe the demands of supervisors for well-specified data and projections from firms have improved risk management at these firms. The stress testing that the Federal Reserve has instituted during the past few years has become an important part of our horizontal, interdisciplinary approach to supervising the largest bank holding companies.

Firm-specific capital planning has also become an important supervisory tool. In November 2011, the Federal Reserve issued a new regulation requiring large banking organizations to submit an annual capital plan; This tool serves multiple purposes. First, it provides a regular, structured, and comparative way to promote and assess the capacity of large bank holding companies to understand and manage their capital positions. Second, it provides supervisors with an opportunity to evaluate any capital distribution plans against the backdrop of the firm's overall capital position, a matter of considerable importance given the significant distributions that some firms made in 2007 even as the financial crisis gathered momentum. Third, at least for the next few years, it will provide a regular assessment of whether large bank holding companies will readily meet the Basel 2.5 and Basel III capital requirements as they take effect in the United States.

A stress test is a critical part of the annual capital plan review. But, as these three different purposes indicate, the capital plan review is about more than using a stress test to determine whether a firm's capital distribution plans are consistent with remaining a viable financial intermediary in adverse economic conditions. As indicated during our capital plan reviews in both 2011 and 2012, the Federal Reserve may object to a capital plan because of significant deficiencies in a firm's capital planning process, as well as because' one or more relevant capital ratios would fall below required levels under the assumptions of stress and planned capital distributions. Likewise, the stress test is relevant not only for its role in the capital planning process. As noted earlier, it also serves other important purposes, not least of which is increased transparency of both bank holding company balance sheets and the supervisory process of the Federal Reserve.

Enhanced Liquidity Standards

As with capital, the financial crisis also brought attention to defects in the liquidity risk-management practices of large financial firms. As seen during the crisis, a financial firm-particularly one with significant amounts of short-term funding—can become illiquid before it becomes insolvent, as creditors run in the face of uncertainty about the firm's viability. While higher levels and quality of capital can mitigate some of this risk, it was widely agreed that quantitative liquidity requirements should be developed. The Basel Committee generated two liquidity standards: one, a Liquidity Coverage Ratio (LCR) with a 30-day time horizon; the other, a Net Stable Funding Ratio (NSFR) with a 1-year time horizon. However, insofar as this was the first-ever effort to specify such requirements, the Governors and Heads of Supervision of the countries represented on the Basel Committee determined that implementation of both frameworks should be delayed while they are subject to further examination and possible revision. As is the case with enhanced capital standards for the largest banking firms, the Basel Committee's liquidity initiatives are consistent with the Federal Reserve's obligation under section 165 of the Dodd-Frank Act to impose more stringent liquidity standards on the largest bank holding companies as well as other systemically important nonbank financial firms.

The LCR has been actively reconsidered within the Basel Committee over the last year or so. As this work proceeds, four types of changes appear particularly ripe for consideration. First, the LCR's definition of high-quality liquid assets should be broadened. In this regard, we support efforts to move away from the current credit risk-based approach and toward a quantitative liquidity-based approach. Second, some of the assumptions embedded in the LCR about run rates of liabilities and the liquidity of assets might be grounded more firmly in actual experience during the crisis, as the LCR may overstate in particular the liquidity risks of commercial banking activities. Third, additional consideration needs to be given to the liquidity risks inherent in trading activities that rely upon large amounts of short-term wholesale funding. Fourth, the LCR could be better adapted to ensure usability of the high-quality liquid asset buffer in appropriate circumstances: for example, by making credibly clear that ordinary minimum liquidity levels need not be maintained in the midst of a crisis. As currently constituted, the LCR may have the unintended effect of exacerbating a period of stress by forcing liquidity hoarding. The Basel Committee will likely suggest a set of changes to the LCR later this year, with a goal of introducing the LCR in 2015. Work on the NSFR is on a considerably slower track; the current plan is for implementation in 2018.

Enhanced Prudential Standards for the Largest Financial Firms

Sections 165 and 166 of the Dodd-Frank Act require the Federal Reserve to establish a broad set of enhanced prudential standards, both for bank holding companies with total consolidated assets of $50 billion or more and for nonbank financial companies designated by the Financial Stability Oversight Council (Council). In addition to enhanced risk-based capital and liquidity requirements and stress testing, the re-

quired standards also include single-counterparty credit limits, an early remediation regime, and risk-management and resolution-planning requirements. Sections 165 and 166 also require that these prudential standards become more stringent as the systemic footprint of a firm increases.

In December, the Federal Reserve issued a package of proposed rules to implement sections 165 and 166 of the Dodd-Frank Act. The Federal Reserve's proposed rules would apply the same set of enhanced prudential standards to covered companies that are bank holding companies and to covered companies that are nonbank financial companies designated by the Council. As we made clear in the proposal, however, the Federal Reserve expects to tailor the application of the enhanced standards to different companies individually or by category, taking into consideration each company's capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the Federal Reserve deems appropriate. The comment period for our enhanced prudential standards proposal closed on April 30. Nearly 100 comment letters were received. The Federal Reserve is currently reviewing those comments carefully as we work to develop final rules.

The Volcker Rule

Section 619 of the Dodd-Frank Act, commonly known as the "Volcker Rule," generally prohibits banking entities from engaging in proprietary trading or acquiring an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund. In October, the Federal Reserve joined the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission in seeking public comment on a proposal to implement the Volcker Rule. The Commodities Futures Trading Commission issued its substantially similar proposal for comment shortly thereafter. Because of the importance and complexity of the issues raised by the statutory provisions that make up the Volcker Rule, the Federal Reserve and other agencies provided the public with a 120-day opportunity to submit comments. The comment period is now closed, and nearly 19,000 public comments were received. The agencies are now working together to review and consider these comments and put final implementing rules in place as soon as practicable.

In April, after consultation with the other agencies, the Federal Reserve issued guidance on a Volcker Rule conformance period that was intended to help limit any confusion about when banking entities will need to comply with the final rules once issued. The Federal Reserve's statement clarified that a banking entity has the full 2-year period provided by the statute (i.e., until July 21, 2014), unless that period is extended by the Board, to fully conform its activities and investments to the requirements of the Volcker Rule, including any final implementing rules adopted by the agencies.

Prudential Supervision of Large Financial Firms

In the wake of the Dodd-Frank Act, the prudential supervision of the largest, most complex financial firms remains a cooperative effort. As before, the law mandates that a variety of Federal and State supervisors execute particular supervisory and examination responsibilities for certain parts of a firm. This allocation of supervisory oversight among different agencies reflects, among other factors, the historical development of various types of financial intermediaries in the United States and a series of legislative decisions about regulatory and supervisory structure.

As the regulator and supervisor of bank holding companies, the Federal Reserve's role in this statutory arrangement is typically that of consolidated regulator and supervisor of the parent holding company. Accordingly, our supervisory program for such firms generally takes a broad view of the activities, risks, and management of the consolidated firm, with a particular focus on the capital adequacy, governance, and risk-management practices and competencies of the firm as a whole.

Many of the principal business activities of the largest financial firms are conducted through the functionally regulated subsidiaries of those firms, such as insured depository institutions, broker-dealers, and insurance companies. As required by section 5 of the Bank Holding Company Act, the Federal Reserve generally relies to the fullest extent possible on the examination and supervision of those subsidiaries by the functional regulators. Together, the Federal Reserve and other functional regulators work to discharge the supervisory and examination responsibility given to each agency for particular parts of a large financial firm in a way that maximizes the expertise and resources of each agency and best ensures the safety and soundness of the consolidated firm and each of its constituent parts.

Just as the financial crisis revealed the need for change in the prudential standards applicable to financial firms and activities, so too did it make clear that important changes in supervisory practices were needed to improve both the micropruden-

tial and macroprudential oversight of banks and bank holding companies. To that end, even before passage of the Dodd-Frank Act, the Federal Reserve began to reorient its supervisory structure and strengthen its supervision of the largest, most complex financial firms.

The most important change has been creation of the Large Institution Supervision Coordinating Committee (LISCC). The LISCC is founded on several principles: that large institution supervision should be more centralized; that it should conduct regular, simultaneous, horizontal (cross-firm) supervisory exercises; and that it should be more interdisciplinary than it has been in the past. Thus, the LISCC includes senior Federal Reserve staff from research, legal and other divisions at the Board, from the markets and payments systems groups at the Federal Reserve Bank of New York, and senior bank supervisors from the Board and relevant reserve banks. Relative to previous practices, this approach to supervision relies more on quantitative methods for evaluating the performance and vulnerabilities of firms.

To date, the LISCC has developed and administered various horizontal supervisory exercises, notably the capital stress tests and the related comprehensive capital reviews of the Nation's largest bank holding companies, and is now extending its activities to coordinate other supervisory processes more effectively. It also has focused its attention on potential implications for financial stability in the United States from stresses arising in Europe.

Review of JPMorgan Chase & Co. Trading Loss

In response to the significant trading losses that were recently announced by JPMorgan Chase & Co. (JPMorgan) as a result of trading operations at the London branch of its national bank, the Federal Reserve—in its capacity as consolidated supervisor of the bank holding company—is working with the OCC, the regulator of the national bank, to review the firm's response and remedial actions. In particular, the Federal Reserve has been assisting in the oversight of JPMorgan's efforts to manage and de-risk the portfolio in question. As this process proceeds, we anticipate also working with the OCC and FDIC to identify the changes in risk measurement, management, and governance that will be necessary to improve risk-control practices surrounding the firm's trading activities and to address trading strategies that led to these losses.

In addition, the Federal Reserve has been looking at other parts of the holding company to determine if governance, risk management, and control weaknesses—similar to those exposed by this incident—are present elsewhere. While we have, to date found no evidence that they are, this review is not yet complete.

Conclusion

The recent financial crisis disrupted the financial system and the broader economy on a scale and scope not seen since the 1930s. Some of the world's largest financial firms collapsed or required Government assistance to stay afloat, sending shock waves through the highly interconnected global financial system. Asset prices fell sharply, flows of credit to American families and businesses slowed dramatically, and millions of people lost their jobs. Extraordinary actions by Governments around the world helped to provide stability, but more than 4 years after the onset of the crisis, the recovery is far from complete. It is critical that we complete the implementation of capital and other prudential measures to prevent another crisis and protect taxpayers from having again to recapitalize financial firms.

Thank you very much for your attention. I would be pleased to answer any questions you may have.

PREPARED STATEMENT OF THOMAS J. CURRY

COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

JUNE 6, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, it is a pleasure to be here as the 30th Comptroller of the Currency to testify as part of the Committee's ongoing hearings on the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act). Before beginning, I want to express my appreciation for the confidence and trust that Members

of this Committee and the President have bestowed upon me to lead the Office of the Comptroller of the Currency (OCC).*

The OCC supervises nearly 2,000 national banks and Federal savings associations (collectively "banks"), which constitute approximately 26 percent of all federally insured banks and thrifts, holding more than 69 percent of all commercial bank and thrift assets. These institutions range in size from nearly 1,800 community banks with assets of $1 billion or less to the Nation's largest and most complex financial institutions with assets exceeding $100 billion. More than 90 percent of the institutions the OCC supervises are community banks and 75 percent of our bank supervision staff directly supports the supervision of these important institutions across the country. At the same time, examiners with diverse experience and specialized skills are embedded in the large banks we regulate to provide continuous ongoing supervision. To meet the supervisory needs of banks with such diversity, the OCC has structured its supervision activities into three lines of business: our Large Bank program, which typically covers banks with assets of $50 billion or more; our Midsize Bank program, which covers banks with assets generally ranging from $10 billion to $50 billion; and our Community Bank program, which is focused on banks under $10 billion in assets. We tailor our supervisory activities for these three groups of institutions to the challenges they face.

The Dodd-Frank Act and rulemakings by the OCC and other agencies have done much to strengthen the regulatory framework for our country's financial institutions. Translating these reforms into improved soundness and fair treatment of customers by individual institutions requires strong, effective supervision. I am committed to strong supervision and to taking additional steps to enhance our supervision where necessary. Strong supervision is a theme that will flow through the balance of my testimony and mark my tenure as Comptroller. The agency has already begun efforts to heighten supervisory expectations among the largest institutions we oversee. This process includes increasing the awareness of risks facing banks and the banking system, reducing risk to manageable levels, and raising expectations for management, capital, reserves, liquidity, risk management, and corporate governance and oversight. This is a process that will take time to accomplish, and we must be vigilant to maintain our course.

In response to the Committee's letter of invitation, my testimony covers five broad topics

- The status of several rulemakings implementing some key provisions of the Dodd-Frank Act;
- A description of the OCC's supervision of community banks summarizing the steps we take to assure that our supervision is consistent, balanced, and reflective of the risks these banks face, as well as the compliance challenges they experience when new rules or policies are introduced;
- An overview of how the Dodd-Frank Act changed the regulatory framework for the supervision of large banking organizations and the mechanisms for regulatory collaboration;
- A discussion of the OCC's large bank supervisory program and how provisions of the Dodd-Frank Act will enhance and supplement our supervision; and
- A summary of our oversight and work underway at JPMorgan Chase (JPMC) related to their recently announced losses.

I. Update on Key Regulatory Reform and Dodd-Frank Act Rulemakings

The OCC has taken action on several key regulatory reform and Dodd-Frank Act rulemakings since our last testimony before this Committee. These are summarized below.

Final Rule To Revise the OCC's Regulations To Remove References to Credit Ratings

The OCC will soon be publishing in the *Federal Register* a final rule that addresses section 939A of the Dodd-Frank Act by removing references to credit ratings from the OCC's regulations dealing with topics other than capital requirements. For example, the investment securities regulation sets forth the types of investment securities that national banks and Federal savings associations may purchase, sell, deal in, underwrite, and hold. Under existing OCC rules, permissible investment securities generally include Treasury securities, agency securities, municipal bonds, and other securities rated "investment grade" by nationally recognized statistical rating organizations such as Moody's, S&P, or Fitch Ratings. The OCC's final rule revises the definition of "investment grade" to remove the reference to credit ratings and

*Statement Required by 12 U.S.C. §250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

replaces it with a new nonratings based creditworthiness standard. To determine that a security is "investment grade" under the new standard, a bank will be required to perform due diligence necessary to establish: 1) that the risk of default by the obligor is low; and 2) that full and timely repayment of principal and interest is expected. Generally, securities with good to very strong credit quality will meet this standard.

In comments on the proposed rule, banks and industry groups expressed concern about the amount of due diligence that the OCC would require a bank to conduct to determine whether an issuer has an adequate capacity to meet financial commitments under a security. The OCC believes that the proposed "investment grade" standard and the due diligence required to meet it are consistent with those under the prior ratings-based standards and existing due diligence requirements and guidance. Even under the prior ratings-based standards, national banks and Federal savings associations of all sizes should not have relied solely on a credit rating to evaluate the credit risk of a security, and have been advised to supplement any use of credit ratings with additional diligence on the credit risk of a particular security. Nevertheless, the OCC recognizes that it may take time for some national banks and Federal savings associations to make the adjustments necessary to make "investment grade" determinations under the new standard. Therefore, the OCC is allowing institutions until January 1, 2013, to come into compliance with the final rule.

To aid this adjustment process, the OCC also will publish guidance to assist banks in interpreting the new standard and to clarify the steps banks can take to demonstrate that they meet their diligence requirements when purchasing investment securities and conducting ongoing reviews of their investment portfolios.

Final Market Risk Capital Rule

On December 21, 2011, the OCC, Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC) issued a notice of proposed rulemaking (NPR) that amended the agencies' January 2011 market risk capital proposal by removing references to credit ratings, consistent with section 939A of the Dodd-Frank Act. The NPR proposed alternative standards of creditworthiness to be used in place of credit ratings to determine the capital requirements for certain debt and securitization positions covered by the market risk capital rule.

I will soon approve for publication in the *Federal Register* the final market risk rule that implements various enhancements adopted by the Basel Committee on Banking Supervision to strengthen the capital requirements that apply to banks' trading activities. The final rule modifies the scope of positions covered by the rule to better capture positions for which the market risk capital rules are appropriate; reduce procyclicality in market risk capital requirements; enhance the rule's sensitivity to risks that are not adequately captured under the current regulatory measurement methodologies; and increase transparency through enhanced disclosures. The rule also removes references to credit ratings from the market risk capital framework and requires banks to receive written approval before making material changes to models used to calculate their market risk capital requirement. The rule will be published once approved by the boards of the FDIC and the FRB.

Basel III Capital Standards

I also will soon approve for publication in the *Federal Register* a set of proposals that would revise the agencies' current "advanced approaches" risk-based capital rules and replace the agencies' current generally applicable risk-based capital rules with rules that implement various enhancements adopted by the Basel Committee. These enhancements, which were more fully discussed in the OCC's December 2011 testimony, include:

- A new, more rigorous definition of capital, which excludes funds raised through hybrid instruments that were unable to absorb losses as the crisis deepened; . Increased minimum risk-based capital requirements, which include increased minimum Tier 1 capital requirements and a new common equity requirement;
- The creation of a capital conservation "buffer" on top of regulatory minimums to be drawn down in times of economic stress and that trigger restrictions on capital distributions (such as dividends), and discretionary bonus payments;
- Enhanced risk-based capital requirements for counterparty credit to capture the risk that a counterparty in a complex financial transaction could grow weaker at precisely the time that a bank's exposure to the counterparty grows larger;
- The addition of a new leverage ratio requirement for larger institutions that incorporates off-balance-sheet exposures; and

- The removal of the references to credit ratings from the agencies' risk-based capital rules, pursuant to section 939A of the Dodd-Frank Act.

The agencies have divided the proposals into three separate NPRs that will be published together in the *Federal Register* to allow interested parties to better understand and focus on the various aspects of the overall capital framework, including which aspects of the rules will apply to which banking organizations. Separating the proposals into three documents will make it easier for banks of all sizes to understand which proposed changes are related to improving the quality and increasing the quantity of capital and which are related to enhancing the risk sensitivity of the calculation of total risk-weighted assets.

Dodd-Frank Stress Tests

The Dodd-Frank Act requires two types of stress testing requirements: stress tests conducted by the company and stress tests conducted by the FRB. The company-run stress test applies to all financial companies, including national banks and Federal savings associations, with total consolidated assets of more than $10 billion, and requires the primary financial regulatory agency of those financial companies to issue regulations implementing the stress test requirements. Company-run stress tests are required semi-annually for financial companies with consolidated assets exceeding $50 billion, and annually for those from $10 to $50 billion in size. The primary financial regulatory agency is required to define "stress test," establish methods for the conduct of the company-conducted stress test that must include at least three different sets of conditions (baseline, adverse, and severely adverse), establish the form and content of the institution's report, and compel the institution to publish a summary of the results of the institutional stress tests.

On January 24, 2012, the OCC published an NPR to implement the company-run stress test for banks. We are currently reviewing the comments we received and are working closely with the FRB and FDIC to ensure that the final rules are consistent and reduce burden to the greatest extent possible by avoiding duplication.

Volcker Rule

Section 619 of the Dodd-Frank Act added a new section 13 to the Bank Holding Company Act (BHCA) that contains certain prohibitions and limitations on the ability of a banking entity and a nonbank financial company supervised by the FRB to engage in proprietary trading and to have certain interests in, or relationships with, a hedge fund or private equity fund. The OCC, FDIC, FRB, and the Securities and Exchange Commission (SEC) issued proposed rules implementing that section's requirements on October 11, 2011. On January 3, 2012, the period for filing public comments on this proposal was extended for an additional 30 days, until February 13, 2012. On January 11, 2012, the Commodity Futures Trading Commission (CFTC) issued a substantively similar proposed rule implementing section 13 of the BHCA and invited public comment through April 16, 2012. The agencies are now considering the more than 18,000 comments received.

On April 19, 2012, the FRB clarified that entities covered by the Volcker Rule have a period of 2 years after the statutory effective date, which would be until July 21, 2014, to fully conform their activities and investments to the requirements of section 619 of the Dodd-Frank Act and any final rules adopted, unless that period is extended by the FRB.

The OCC, FDIC, SEC, and CFTC announced that they plan to administer their oversight of banking entities under their respective jurisdictions in accordance with the FRB's conformance rule and statement of April 19.

Lending Limits

The OCC's lending limit rules at 12 U.S.C. §84 provide that the total loans and extensions of credit by a national bank to a person outstanding at one time shall not exceed 15 percent of the unimpaired capital and unimpaired surplus of the bank if the loan is not fully secured, plus an additional 10 percent of unimpaired capital and unimpaired surplus if the loan is fully secured by certain types of collateral. Section 610 of the Dodd-Frank Act amends this provision to expand the definition of "loans and extensions of credit" to include any credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction between a national bank and that person. This amendment is effective July 21, 2012.

The OCC plans to issue a rule shortly to establish how the credit exposures from these types of transactions should be measured for lending-limit purposes. In implementing these provisions, the OCC has been mindful of opportunities to minimize complexity, particularly for community banks, and of providing sufficient time for banks to comply with the new requirements.

II. OCC's Commitment to and Supervision of Community Banks

The OCC's community bank supervision program is built around our local field offices, staffed by local examiners, based in more than 60 cities throughout the United States in close proximity to the banks they supervise. Every community bank is assigned to an examiner who monitors the bank's condition on an ongoing basis and who serves as the focal point for communications with the bank.

The OCC's structure ensures that community banks receive the benefits of highly trained examiners with local knowledge and experience, along with the resources and specialized expertise that a nationwide organization provides. Examiners conduct their examinations using the Community Bank Supervision section of the Comptroller's Handbook that tailors procedures to community banks. While the OCC's bank supervision policies and procedures establish a common framework and set of expectations, examiners tailor their supervision of each community bank to its individual risk profile, business model, and management strategies. As a result, the OCC's Assistant Deputy Comptrollers are given considerable decision-making authority, reflecting their experience, expertise, and their on-the-ground knowledge of the institutions they supervise.

The OCC has mechanisms in place to ensure that examiners apply our supervisory policies, procedures, and expectations in a consistent and balanced manner. The responsible manager reviews and signs off on each report of examination before being finalized. When significant issues are identified and an enforcement action is already in place, or is being contemplated, additional levels of review occur prior to finalizing the examination conclusions. The OCC also has formal quality assurance processes, overseen by the agency's Enterprise Governance office that reports directly to me, that assess the effectiveness of our supervision and compliance with OCC policies through periodic, randomly selected reviews of the supervisory record.

As a former State banking commissioner, I have a keen appreciation for the critical role that community banks play in providing consumers and small businesses in communities across the Nation with essential financial services as well as the credit that is critical to economic growth and job creation. While community banks comprise about 11 percent of the banking assets in our country, they make 39 percent of the small business loans that keep America working. I am committed to making sure our supervision of these institutions is fair and balanced, and that wherever possible, we minimize their regulatory and compliance burdens.

As the OCC has previously testified, while the focus of the Dodd-Frank Act is generally on larger financial institutions, other provisions broadly amend banking and financial laws in ways that affect the entire banking sector, including community banks. [1] Some of these involve provisions where the OCC has rulemaking authority, while others fall outside of the OCC's jurisdiction. As we implement regulations for the Dodd-Frank Act and other key reform efforts, one of my early directives to the OCC staff has been to assess the potential impact on smaller institutions, seek ways to minimize potential burden, and explain and organize our rulemakings in ways that help community bankers understand the scope and application of the rules to their institutions.

The companion guidance to our rulemaking to remove credit ratings from our investment securities regulations, described above, is one example of how we are trying to minimize burden on smaller banks. In implementing this provision of the Dodd-Frank Act, our goal has been to meet the objective of the statute while recognizing the effectiveness of the tools and analyses that well-managed community banks have routinely used to aid their credit analysis and investment decisions.

III. Dodd-Frank Impact on Supervision of Large Banking Organizations

The Dodd-Frank Act will have a significant and lasting impact on the supervision and oversight of our Nation's large financial firms. Indeed, among the Act's key objectives are to strengthen the oversight, regulation, and resolution regimes applicable to large financial organizations to lessen the potential that disruptions or failures could have on the stability of the U.S. financial system. The Act also seeks to promote greater market stability through increased transparency and oversight of swaps and other derivative activities. Finally, the Act also seeks to strengthen consumer protection related to financial products and services.

The Dodd-Frank Act establishes a variety of mechanisms to achieve these objectives. Some of these mechanisms, such as the risk retention, Volcker, and swap margin and central counterparty and clearing provisions, are targeted at how and where various financial activities and risk taking are to be conducted in the future. As more fully described in the OCC's December 2011 and March 2012 testimonies be-

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[1] *See, http://www.occ.gov/news-issuances/congressional-testimony/2011/pub-test-2011-42-written.pdf.*

fore this Committee, work on these rulemakings is underway.[2] Other provisions established new or expanded regulatory authorities. These include the Title II orderly liquidation provisions and tools provided to the FDIC and the FRB; the transfer of powers and functions from the Office of Thrift Supervision to the OCC; and the creation of the Consumer Financial Protection Bureau (CFPB) and the Financial Stability Oversight Council (FSOC). Finally, other provisions, most notably those related to heightened prudential standards are designed to strengthen the risk management, capital, and liquidity that govern and support risk-taking activities.

The financial crisis underscored that supervisors must be cognizant not only of what is going on within the individual firms they oversee, but also how those activities affect, or can be affected by, events at other firms, markets, and the broader economy. The Dodd-Frank Act established the FSOC to provide a formal body to assess and exchange such information. The OCC is an active participant in FSOC and its various operating committees, including those developing and assessing potential designations for systemically important financial market utilities and nonbank financial firms; the systemic risk committee, charged with assessing and monitoring potential emerging systemic issues; and the committee providing input to the FRB's heightened prudential FSOC meeting last month and believe it will be a valuable forum for exchanging market intelligence and coordinating regulatory actions on a variety of cross-cutting issues that may affect OCC-supervised large institutions. One such example that was widely reported from the most recent FSOC meeting included a discussion, led by the OCC, of risks and supervisory actions related to reports of JPMC activities and disclosed losses—a topic also discussed later in this testimony.

To promote consistent and comprehensive oversight of large banking organizations, the Dodd-Frank Act appropriately requires close collaboration among the Federal financial agencies with respect to rulemaking and various ongoing supervisory activities. In this regard, two provisions of the Act have had a direct impact on the scope and nature of the OCC's supervisory activities.

The first, and most immediate impact, was the transfer to the OCC of all functions of the OTS relating to Federal savings associations. From an operational perspective, this transfer was successfully completed last July, and the ongoing supervision of more than 600 Federal savings associations has been integrated into our supervisory programs. The integration of the OTS into the OCC will help achieve a more consistent supervisory regime for federally chartered depository institutions. In this regard, and as discussed more fully in the OCC's December 2011 testimony, we are conducting a comprehensive, multiphased review of our regulations, as well as those of the OTS, to eliminate duplication, reduce unnecessary burden, and provide consistent treatment, where appropriate, for both national banks and Federal savings associations. A similar effort is underway to integrate the more than 1,000 OTS policies into a consolidated OCC policy framework.

While we believe having a common set of rules and policies will benefit national banks and Federal savings associations, we recognize that these changes can create uncertainty for Federal savings associations. To help Federal savings associations understand these changes and the OCC's approach to supervision, we continue to hold various outreach meetings and teleconferences for Federal savings associations. These opportunities allow Federal savings association executives to voice concerns, to get answers to their questions, and to gain a better understanding of supervisory issues of specific interest to them. We are also in the process of re-establishing the OTS' advisory committees for mutual savings associations and minority institutions to provide a venue for industry input on the unique challenges facing those institutions.

The second shift in OCC supervisory responsibilities as the result of Dodd-Frank has been the transfer of oversight responsibility for compliance with certain Federal consumer laws to the CFPB for national banks and Federal savings associations with total assets greater than $10 billion. To minimize regulatory burden on institutions, the Dodd-Frank Act requires the CFPB to coordinate its activities with the supervisory activities conducted by the prudential regulators. Section 1025 requires the CFPB to consult with the prudential regulators regarding respective schedules for examining an institution. Similarly, the CFPB and the prudential regulators are required to conduct their respective examinations simultaneously in an insured depository institution and to share and comment on related draft reports of examination that result from the simultaneous examinations. The law also provides that the regulated institution may opt out of a simultaneous examination by the prudential

[2] *See, http://www.occ.gov/news-issuances/congressional-testimony/2011/pub-test-2011-142-written.pdf* and *http://www.occ.gov/news-issuances/congressional-testimony/2012/pub-test-2012-50-written.pdf.*

regulator and the CFPB. I am pleased to report that the OCC and other Federal banking agencies recently signed and earlier this week published a Memorandum of Understanding that implements these coordination requirements in a realistic and practical manner.

With respect to supervision of individual large banking organizations, the OCC serves as the primary Federal banking regulator for activities conducted within the national bank or Federal savings association charter and its subsidiaries, except for compliance with statutes and regulations where jurisdiction has been expressly provided to another supervisor, such as the SEC for certain broker-dealer activities, and the CFPB for certain Federal consumer laws. Since most large banks are part of a bank holding company, we work closely with the FRB in planning and conducting our supervisory activities for these institutions.

Successful implementation of the heightened prudential standards provisions of the Dodd-Frank Act will require close collaboration between the OCC and the FRB. For example, bank holding companies subject to the heightened prudential standards, and their subsidiary national banks and Federal savings associations, will be subject to multiple stress tests, including the annual Comprehensive Capital Analysis and Review (CCAR), and the supervisory and company-run stress tests set forth in the FRB's Heightened Prudential Standards rules and the OCC's stress test rule. It is important that our agencies work together to align resources and strategy, and to ensure consistency in scenarios and models, in both the CCAR and Dodd-Frank Act stress testing processes.

IV. OCC Supervision of Large Banks and the Dodd-Frank Act

Overview of the OCC's Supervisory Program for Large Banks

The OCC's Large Bank supervision program is structured to promote consistent risk-based supervision. It is a centralized program headquartered in Washington with a national perspective that facilitates coordination across large institutions.

The foundation of the OCC's supervisory efforts is our continuous, on-site presence of examiners at each of the 19 largest banking companies. These on-site teams are led by an Examiner-In-Charge (EIC) who manages a staff of seasoned examiners, generally with 20 or more years of experience across numerous banks and multiple business cycles, and possessing advanced skills in key risk areas such as credit, capital markets, and compliance. In addition, certain supervisory activities are staffed by our team of PhD economists from the OCC Economics Department. The examiners are also supplemented by lawyers, other economists, as well as policy and subject matter experts to support their ongoing supervision.

The on-site examination teams have three main objectives. The first is to know the objectives of the bank and its lines of business, the key risks, and the controls that are put in place to manage them. The second is to assess the levels of risk in the bank and the quality of risk management over the course of the examination cycle. Finally, examiners are charged with communicating examination findings, concerns, and ratings through our CAMELS and Risk Assessment System. Examiners communicate by meeting with bank management and the board of directors, and through written supervisory letters and reports of examination. They identify concerns and ensure that corrective actions are taken, through the supervisory process, or if needed, appropriate enforcement actions.

To enhance our ability to identify key risks as well as emerging issues and share best practices across the large banks, we have examiner network groups across eight major disciplines: Commercial Credit, Retail Credit, Mortgage Banking, Capital Markets, Asset Management, Information Technology, Operational Risk, and Compliance. These groups share information, concerns, and policy application among examiners. They also identify areas of common interest as well as risks that are elevated or emerging. The EICs and leadership teams of each of the network groups work closely with specialists in our Supervision Policy and Risk Analysis Divisions to promote consistent application of supervisory standards and coordinated responses to emerging issues.

Examinations are conducted pursuant to risk-based supervisory strategies that are developed for each institution. Although each strategy is tailored to the business model and risk profile of the individual institution, the strategy development process is governed by supervisory objectives established annually by our senior supervision management team. Through this planning process, the OCC identifies key risks and issues that cut across the industry and promotes consistency in areas of concern. Each strategy is reviewed and approved by the appropriate Large Bank Deputy Comptroller. In addition, a Quality Assurance group within our Large Bank program reviews selected strategies as part of a structured process review to ensure that examination activities are executed consistently and in a quality manner.

It is important to remember that the job of risk management is not to eliminate losses. Rather, risk management ensures that risk exposures are fully identified and understood by bank management and directors to allow them to make informed business decisions about the firm's risks, and that the bank has sufficient capital, reserves, and liquidity to withstand a range of potentially adverse outcomes. Banks must manage their risks effectively to meet the credit and borrowing needs of the customers and communities they serve.

Resident examiners apply risk-based supervision to a broad array of issues and risks, including credit, liquidity, price, interest rate, compliance, and operational risks. The primary focus of examiners is to determine whether banks have sound risk control processes commensurate with the nature of their risk-taking activities, capital, reserves, and liquidity. Given the millions of transactions that large banks conduct daily across varied product lines and businesses, examiners do not review every transaction in a bank.

OCC examiners probe to see where activities, earnings, or losses diverge from expectations to a degree indicative of a breach of approved parameters or breakdown of controls. For example, examiners look for lending or trading activities operating outside approved limits, especially where risk management activities did not identify or escalate such instances; and for models breaking or not going through proper validation. Risk management seeks to mitigate and control risk but not eliminate it entirely. Losses occur even when all controls function properly. That is why banks are required to maintain capital, reserves, and liquidity to absorb adverse outcomes and unexpected losses.

When we find weaknesses or deficiencies, we communicate them to bank senior management and require corrective actions. Most often this is accomplished through "Matters Requiring Attention" (MRA) that are sent to the bank's senior management and board of directors. When needed, we take more formal enforcement actions.

OCC Actions and the Dodd-Frank Act Require Stronger Risk Management for Systemically Important Banks

At the OCC, we have raised the bar on our supervisory expectations for the largest banks we supervise. Large banks are critically important to the vitality of our economy and the orderly functioning of the capital markets. As a result, they must be managed and governed in a higher quality manner than less systemically important banks. Our experience in the recent crisis showed that we needed to elevate expectations with respect to balance sheets as well as governance and oversight processes.

Stronger Capital, Reserves, and Liquidity Standards

Since the onset of the financial crisis, we directed the largest institutions to strengthen their capital, reserves, and liquidity positions. As a result, the quality and level of capital at national banks and bank holding companies with total assets over $50 billion have improved significantly. The median percentage of Tier 1 common capital relative to total assets for bank holding companies increased from 5.2 percent to more than 7 percent, while the comparable ratio for national banks and Federal savings institutions rose from 6.4 percent to 8.7 percent, over that same period.

Under scrutiny of our examiners, the largest banks have more than doubled their loan loss reserves as a percentage of gross loans since the end of 2007, from 1.4 percent to 2.9 percent. Similarly, the largest banks have materially strengthened their liquidity buffers through increases in short-term liquid assets that can be used to meet unanticipated liquidity demands and through a decreased reliance on short-term, volatile funding. While these are positive developments, we are taking actions to ensure that these are permanent and not just temporary improvements.

In concert with the Basel Committee, we are raising both the quality and quantity of regulatory capital that banks generally must hold. Consistent with section 171 of the Dodd-Frank Act, these enhanced capital requirements will also apply to bank holding companies. These changes are being implemented by the forthcoming Basel III capital rulemakings, which were previously described. Under the proposed rules, large banks subject to the "advanced approaches" capital regime will face additional capital requirements that will not apply to smaller banks. These include a countercyclical capital charge, which banking supervisors can activate to curb excessive credit growth, and a supplemental leverage ratio that will capture off-balance-sheet exposures. This enhanced leverage ratio is broadly consistent with section 165 of the Dodd-Frank Act, which directs that off-balance-sheet activities be included in the regulatory capital calculation for bank holding companies with total consolidated assets equal to or greater than $50 billion. Basel III also calls for adopting a capital

surcharge that would apply only to the 29 largest global, systemically important banks, seven of which are U.S. entities. The FRB supervises all of these bank holding companies, and the OCC supervises the national banks in five of these companies. It is envisioned that this provision will be included in the FRB's heightened prudential capital standards rule as part of its implementation of section 165.

Basel III also introduces two explicit quantitative minimum liquidity ratios to assist a bank in maintaining sufficient liquidity during periods of financial distress: the Liquidity Coverage Ratio and the Net Stable Funding Ratio. These ratios are designed to achieve two separate but complementary objectives. The Liquidity Coverage Ratio, with a 1-month time horizon, addresses short-term resilience by ensuring that a bank has sufficient high quality liquid resources to offset cash outflows under acute short-term stresses. The Net Stable Funding Ratio is targeted toward promoting longer-term resilience by creating additional incentives for a bank to fund its ongoing activities with stable sources of funding. Its goal is to limit over-reliance on short-term wholesale funding during times of robust market liquidity and to encourage better assessment of liquidity risk across all on- and off-balance-sheet items.

The Basel Committee included a lengthy implementation timeline for both ratios to provide regulators the opportunity to conduct further analysis and to make changes as necessary. The OCC is continuing its work with the Basel Committee to develop and recommend changes to the Liquidity Coverage Ratio to ensure that it will produce appropriate requirements and incentives, especially during economic downturns, and to otherwise limit potential unintended consequences.

These explicit liquidity thresholds, once fully implemented, will complement the more rigorous liquidity risk management expectations that the OCC and other banking agencies issued in 2010 and that are helping to form the enhanced liquidity standards the FRB is promulgating as part of the heightened prudential standards under section 165 of the Dodd-Frank Act. In the interim, the OCC this week published a revised Liquidity Risk Management booklet as part of its Comptroller's Handbook series. This booklet forms the framework for our liquidity examinations. While the core concepts in the booklet apply to national banks and Federal savings associations of all sizes, the booklet emphasizes that the complexity and sophistication of liquidity risk management, along with the liquidity positions held must be tailored to a bank's risk profile and scope of activities.

Heightened Expectations for Strong Corporate Governance and Oversight

Higher supervisory expectations, along with sharper execution by bank management and independent directors in fundamental areas, will go a long way toward maintaining the improvements achieved since the financial crisis and minimizing the probability and impact of future crises. We set higher expectations for large banks in five specific areas.

Board willingness to provide credible challenge. A key element in corporate governance is a strong, knowledgeable board with independent directors who provide a credible challenge to bank management. The capacity to dedicate sufficient time and energy in reviewing information and developing an understanding of the key issues related to bank activities are critical to being an effective director. Informed directors are well positioned to engage in value-added discussions that provide knowledgeable approvals and guidance. Effective directors prudently question the propriety of strategic initiatives, talent decisions, and the balance between risk taking and reward. And obviously, it is essential to the ability of directors to perform this role to have effective information flow and risk identification within the organization.

Talent management and compensation. Human capital is a key asset in any organization, and we expect large banks to have a well defined personnel management process that ensures appropriate quality staffing levels and provides for orderly succession. Large bank management processes are typically extensive. OCC EICs are enhancing their knowledge in this area and incorporating their assessments into the "management" rating in CAMELS, with particular focus on the adequacy of current staffing levels, the ability to provide for orderly succession, the proactive identification of staffing gaps that require external hires, and appropriate compensation tools to motivate and retain talent. Of particular importance is the need to ensure that incentive compensation structures balance risk and financial rewards and are compatible with effective controls and risk management. This is a key objective of the interagency guidance on sound incentive compensation that the OCC, FRB, and FDIC issued in June 2010, and the proposed rulemaking that the Federal banking agencies, the National Credit Union Administration, the SEC, and the Federal Housing Finance Agency have issued to implement the incentive-based compensation provisions in the Dodd-Frank Act. Work on that rulemaking is underway.

Defining and communicating risk tolerance expectations across the company. Consistent with prudent governance practices, banks must define and communicate acceptable risk tolerance, and results need to be periodically compared to pre-defined limits. As banks have grown, the process of defining and measuring risk tolerance has typically been confined to the business unit and more micro levels. While these lower level risk limits can generally control individual areas of risk taking, they do not enable senior management or board members to monitor or evaluate concentrations or risk levels at the broader firm level. Examiners are directing banks to complement existing risk tolerance structures with measures and limits of risk addressing the amount of capital or earnings that may be at risk on a firm-wide basis, the amount of risk that may be taken in each line of business, and the amount of risk that may be taken in each of the key risk categories monitored by the banks. This process will result in better identification and measurement of concentrations, with attendant monitoring and controls.

Development and maintenance of strong audit and risk management functions. The recent crisis reinforced the importance of quality audit and risk management functions. The scale and breadth of large banks presents added challenges to the roles of executive management and directors in knowing the risk profile and whether pre-defined policies and procedures are being followed appropriately. While regulators operated for many years with the premise that satisfactory[3] oversight functions were generally sufficient, the financial crisis has led us to conclude that large banks should not operate with anything less than strong audit and risk management functions. To meet this higher standard, we have directed bank audit and risk management committees to perform gap analyses relative to OCC's standards and industry practices and to take appropriate action to improve their audit and risk management functions. We expect members of the bank's board and its executive management team to ensure audit and risk management teams are visibly and substantively supported. As part of their ongoing supervision, OCC examiners are evaluating the state of these key oversight functions and identifying areas that require strengthening.

Sanctity of the charter. While holding companies of large banks are typically managed on a line of business basis, directors at the bank level are responsible for oversight of the bank's charter—the legal entity. Such responsibility requires separate and focused governance. We have reminded the boards of banks that their primary fiduciary duty is to ensure the safety and soundness of the national bank or Federal savings association. Execution of this responsibility involves focus on the risk and control infrastructure necessary to maintain it. Directors must be certain that appropriate personnel, strategic planning, risk tolerance, operating processes, delegations of authority, and controls are in place to effectively oversee the performance of the bank. The bank should not simply function as a booking entity for the holding company. It is incumbent upon bank directors to be mindful of this primary fiduciary duty as they execute their responsibilities.

V. JPMorgan Chase Loss and OCC Role and Responsibilities

With this background, let me turn to the recently announced losses at JPMC. This event raises questions about the adequacy and rigor of JPMC's risk management practices that we are actively examining.

JPMC is a $2.3 trillion bank holding company with approximately $128 billion in Tier 1 common capital as of March 31, 2012. The FRB oversees the holding company and its affiliates. The OCC oversees JPMC's national banks and various subsidiaries. The lead national bank has approximately $1.8 trillion in total consolidated assets and $101 billion in Tier 1 common capital. The OCC's supervisory team includes approximately 65 on-site examiners who are responsible for reviewing nearly all facets of the bank's activities and operations, including commercial and retail credit, mortgage banking, trading and other capital markets activities, asset liability management, bank technology and other aspects of operational risk, audit and internal controls, and compliance with the Bank Secrecy Act, and anti-money laundering laws and the Community Reinvestment Act. These on-site examiners are supported by additional subject-matter experts from across the OCC.

Given the scale of the bank, the loss by JPMC affects its earnings, but does not present a solvency issue. JPMC, like other large banks, has improved its capital, reserves, and liquidity since the financial crisis, and its levels are sufficient to absorb this loss. The Basel III rulemakings described earlier will further increase the required level of high-quality capital for all U.S. banks, and work underway by the

[3] OCC examiners rate the quality of the bank's audit function and the quality of risk management as weak, satisfactory, or strong.

Financial Stability Board will further increase capital requirements for systemically significant firms, like JPMC.

Similarly, the events at JPMC do not threaten the broader financial system. Under current market conditions, the JPMC effort to manage its positions is not creating an unusual risk of contagion to other banks. Beyond JPMC, we have directed OCC examiners to evaluate the risk management strategies and practices in place at other large banks, and examiners have reported that there is no activity similar to the scale or complexity of JPMC. However, this is a continuing focus of our supervision.

The activities that generated the reported $2 billion loss were conducted in the national bank by JPMC's Chief Investment Office (CIO), which is responsible for the bank's asset-liability management activities. This asset-liability management function is separate from JPMC's investment banking business, where most trading and market making takes place. The CIO reports to the Chief Executive Officer of JPMC. Its activities are conducted globally but managed and controlled out of JPMC's New York offices. These activities are supervised by OCC staff assigned to the JPMC headquarters in New York. Part of our ongoing review includes an evaluation of this structure, its oversight, and controls.

In 2007 and 2008, the bank constructed a portfolio designed to partially offset credit risk using credit default swaps to help protect the company from potential credit losses in a stressed global economy. This strategy was reflected in regular reports received by OCC examiners. The OCC focused on the risk management systems and controls that the bank employed to mitigate credit risk in its portfolio. For several years thereafter, risk levels operated within bank-approved stress and other limits.

In late 2011 and early 2012, bank management revised its strategy and decided to offset it original position and reduce the amount of stress loss protection. The instruments chosen by the bank to execute the strategy were not identical to the instruments used in the original position, which introduced basis, liquidity, and other risks. As the new strategy was executed in the first quarter, actual performance deviated from expectations, and resulted in substantial losses in the second quarter. Whether risk management controls, procedures, and reports were properly structured, reviewed, approved, and acted upon in the execution of this strategy is another focus of our ongoing examination.

In April 2012, as part of our supervisory activities, OCC examiners met with bank management to discuss the bank's transaction activity and the current state of the position. OCC examiners directed the bank to provide additional details regarding the transactions, their scope, and risk. Our examiners were in the process of evaluating the bank's current position and strategy when, at the end of April and during the first days of May, the value of the position deteriorated rapidly.

Since that time, the OCC has been meeting daily with bank management with respect to the bank's response to this situation, to re-evaluate the risk management activities and controls of the bank and how they applied to its CIO function, and to determine what additional action is necessary. This includes the ongoing daily oversight of the bank's actions to mitigate and reduce the risk of the positions at issue. We and the Federal Reserve are conducting reviews in the bank and are sharing information with the FDIC and other regulators.

We are also undertaking a two-pronged review of our supervisory activities and response. The first component is focused on evaluating the adequacy of current risk controls and risk governance at the bank, informed by their application to the positions at issue. The second component evaluates the lessons learned from this episode that could enhance risk control and risk management processes at this and other banks and improve OCC supervisory approaches. Consistent with our supervisory policy of heightened expectations for large banks, we will require that the bank adhere to the highest risk management standards.

We are not limiting our inquiry just to the particular transactions at issue. We will assess not just the adequacy of risk management and controls for the positions now spotlighted, but also activities in comparable bank operations. We will use these events to more broadly evaluate the effectiveness of the bank's risk management throughout the firm and to identify ways to improve our supervision.

The first prong of our approach involves our on-site exam team focusing on three broad areas. To begin with, we are actively assessing the quality of management and risk management in the CIO function, including decision making; board oversight, including whether the risk committee is appropriately informed and engaged; the types and reasonableness of risk measurement metrics and limits; the model governance review process; and the quality of work by the independent risk management team as well as internal audit. We are also assessing the adequacy of the information provided within the bank and made available to the OCC to evaluate the

risks and risk controls associated with the positions undertaken by the CIO. Finally, we are evaluating the compensation process of the CIO and will assess the bank's determination on "claw backs" as part of that analysis. If corrective action is warranted, we will pursue and implement appropriate informal and/or formal remedial measures.

Working on a parallel track, as part of the second prong of our supervisory response, we are evaluating the events leading up to and through the bank announcement of losses associated with the CIO, and what these events teach us to improve risk management and to enhance our supervisory activity. Particular attention is being directed to the rationale for the transactions and how they fit within the framework of the bank's risk management processes; the quality and extent of information provided to the OCC; and consistency of the bank's activities with OCC supervisory guidance.

We are reviewing the bank's management information systems, committee minutes, audit reports, and conducting discussions examiners to establish a detailed chronology of events surrounding the CIO decision-making and the resulting losses. Our analysis will focus on where breakdowns or failures occurred. This will include assessments of senior management communication and monitoring of strategies; business judgment and execution; the articulation of risk tolerance relative to strategy; risk measurement (including models, limits, stress scenarios, and changes to those tools during the period in question); flow of information, proper authority, and approvals; and the appropriateness and timeliness of particular actions.

As part of this second prong of our supervisory response, we are also assessing relevant audit or examination findings and whether they were addressed; how the risks associated with the strategy were recognized and evaluated; whether there was an effective exchange of views among the business unit and control groups; whether incentives were properly aligned with desired behaviors; and whether the bank's actions were consistent with OCC supervisory guidance and expectations. Again, if corrective action is warranted, we will pursue and implement appropriate informal and/or formal remedial measures.

Finally, a vital part of this second component of our supervisory effort is identifying the lessons learned for improving the effectiveness of our supervision. The areas that we will explore here include whether the quality and extent of information available to OCC examiners was sufficient to permit an understanding of the risk and management processes in place to govern it. We will also determine what, in retrospect, the OCC could have done differently, and how to ensure that the risk management processes of this bank—and others—are effective.

I should also note that the OCC is not drawing any conclusion about whether the activities of JPMC's CIO would be subject to the Volcker Rule. It is premature to reach any conclusion based upon the facts and information as they currently exist.

VI. Conclusion

I appreciate the opportunity to appear before this Committee. While my testimony reports significant progress on implementing the Dodd-Frank Act and other reforms and shares insight into our ongoing efforts to enhance supervision of community banks and large banks, I want to stress my commitment to ensuring this process continues. The recent events at JPMC also remind us of the need to continuously assess OCC's supervisory processes. I look forward to providing additional information to the Committee throughout my tenure as Comptroller and continuing to share how we are meeting our commitment to strong, effective, fair, and balanced supervision of the national banks and Federal savings associations that we supervise.

PREPARED STATEMENT OF MARTIN J. GRUENBERG

ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

JUNE 6, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today on the Federal Deposit Insurance Corporation's efforts to enhance bank supervision and reduce systemic risk. I will summarize the FDIC's progress in implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), with a particular emphasis on the FDIC's implementation of the Title II Orderly Liquidation Authority, as well as how new rules promulgated under the Act affect community banking institutions. Before concluding, I will also briefly address the implications of the recent trading losses at JPMorgan Chase.

Implementation of the Dodd-Frank Act: Measures To Address Systemic Risk

The economic dislocations we have experienced in recent years, which have far exceeded those associated with any recession since the 1930s, were the direct result of the financial crisis of 2007–08. The reforms enacted under the Dodd-Frank Act were aimed at addressing the root causes of the crisis. Foremost among these reforms were measures to curb excessive risk-taking at large, complex banks and nonbank financial companies, where the crisis began. Title I of the Dodd-Frank Act includes new provisions that enhance prudential supervision and capital requirements for systemically important financial institutions (SIFIs), while Title II authorizes a new orderly liquidation authority that significantly enhances the ability to resolve a failed SIFI without contributing to additional financial market distress.

SIFI Resolution Authorities. The most important new FDIC authorities under the Dodd-Frank Act are those that provide for enhanced resolution planning and, if needed, the orderly resolution of SIFIs. Prior to the recent crisis, the FDIC's receivership authorities were limited to federally insured banks and thrift institutions. There was no authority to place the holding company or affiliates of an insured institution or any other nonbank financial company into an FDIC receivership to avoid systemic consequences. The lack of this authority severely constrained the ability of the Government to resolve a SIFI and contributed to the excessive risk taking that led to the crisis.

Since passage of the Dodd-Frank Act, the FDIC has taken a number of steps to carry out its new systemic resolution responsibilities. First, the FDIC established a new Office of Complex Financial Institutions (OCFI) to carry out three core functions:

- monitor risk within and across these large, complex financial firms from the standpoint of resolutions and risk to the Deposit Insurance Fund;
- conduct resolution planning and develop strategies to respond to potential crises; and
- coordinate with regulators overseas regarding the significant challenges associated with cross-border resolution.

For the past year, the OCFI has been developing internal resolution plans in order to be ready to resolve a failing systemic financial company. These internal FDIC resolution plans, developed pursuant to the Orderly Liquidation Authority provided under Title II of the Dodd-Frank Act, apply many of the same powers that the FDIC has long used to manage failed-bank receiverships to a failing SIFI. This internal resolution planning work is the foundation of the FDIC's implementation of its new resolution responsibilities under the Dodd-Frank Act.

The FDIC has largely completed the basic rulemaking necessary to carry out its responsibilities under the Dodd-Frank Act. In July of last year, the FDIC Board approved a final rule implementing the Title II Orderly Liquidation Authority. This rulemaking addressed, among other things, the priority of claims and the treatment of similarly situated creditors. Last September, the FDIC Board adopted two rules regarding resolution plans that systemically important financial institutions themselves will be required to prepare—the so-called "living wills." The first resolution plan rule, jointly issued with the Federal Reserve Board, requires bank holding companies with total consolidated assets of $50 billion or more, and certain nonbank financial companies that the Financial Stability Oversight Council (FSOC) designates as systemic, to develop, maintain, and periodically submit resolution plans to regulators.

Complementing this joint rulemaking, the FDIC also issued another rule requiring any FDIC-insured depository institution with assets over $50 billion to develop, maintain, and periodically submit plans outlining how the FDIC would resolve the institution through the traditional resolution powers under the Federal Deposit Insurance Act. These two resolution plan rulemakings are designed to work in tandem and complement each other by covering the full range of business lines, legal entities, and capital-structure combinations within a large financial firm. Both of these resolution plan requirements will improve efficiencies, risk management, and contingency planning at the institutions themselves. Importantly, they will supplement the FDIC's own resolution planning work with information that would help facilitate an orderly resolution in the event of failure. With the joint rule final, the FDIC and the Federal Reserve Board have started the process of engaging with individual companies on the preparation of their resolution plans. The first plans, for companies with nonbank assets over $250 billion, are due in July.

Section 210 of the Dodd-Frank Act requires the FDIC to "coordinate, to the maximum extent possible" with appropriate foreign regulatory authorities in the event

of a resolution of a covered financial company with cross-border operations. The FDIC has been working diligently on both multilateral and bilateral bases with our foreign counterparts in supervision and resolution to address these crucial cross-border issues.

The FDIC has participated in the work of the Financial Stability Board through its membership on the Resolution Steering Group, the Cross-border Crisis Management Group and a number of technical working groups. The FDIC also has co-chaired the Basel Committee's Cross-border Bank Resolution Group since its inception in 2007. Since the internationally active SIFIs (termed Global- or G–SIFIs) present complex international legal and operational issues, the FDIC is also actively reaching out on a bilateral basis to the foreign supervisors and resolution authorities with jurisdiction over the foreign operations of key U.S. firms. The goal is to be prepared to address issues regarding cross-border regulatory requirements and to gain an in-depth understanding of cross-border resolution regimes and the concerns that face our international counterparts in approaching the resolution of these large international organizations. As we evaluate the opportunities for cooperation in any future resolution, and the ways that such cooperation will benefit creditors in all countries, we are forging a more collaborative process as well as laying the foundation for more reliable cooperation based on mutual interests in national and global financial stability.

Although U.S. SIFIs have foreign operations in dozens of countries around the world, those operations tend to be concentrated in a relatively small number of key foreign jurisdictions, particularly the United Kingdom (U.K.). While the challenges to cross-border resolution are formidable, they may be more amenable than is commonly thought to effective management through bilateral cooperation.

The focus of our bilateral discussions is to: (i) identify impediments to orderly resolution that are unique to specific jurisdictions and discuss how to mitigate such impediments through rule changes or bilateral cooperation and (ii) examine possible resolution strategies and practical issues related to implementation of such strategies with respect to particular jurisdictions. This work entails gaining a clear understanding of how U.S. and foreign laws governing cross-border companies will interact in any crisis. Our initial work with foreign authorities has been encouraging. In particular, the U.S. financial regulatory agencies have made substantial progress with authorities in the U.K. in understanding how possible U.S. resolution structures might be treated under existing U.K. legal and policy frameworks. We have engaged in in-depth examinations of potential impediments to efficient resolutions and are, on a cooperative basis, in the process of exploring methods of resolving them.

To facilitate bilateral discussions and cooperation, the FDIC is negotiating the terms of memoranda of understanding pertaining to resolutions with regulators in various countries. These memoranda of understanding will provide a formal basis for information sharing and cooperation relating to our resolution planning and implementation functions under the legal framework of the Dodd-Frank Act.

Financial Stability Oversight Council (FSOC). The FSOC, chaired by the Secretary of the Treasury and comprising all of the key Federal financial regulatory bodies, was designed to fill the gaps in oversight between existing regulatory jurisdictions and create common accountability for identifying and constraining risks to the financial system as a whole. Among other requirements, the Dodd-Frank Act directs the FSOC to facilitate regulatory coordination and information sharing among its members regarding policy development, rulemaking, supervisory information, and reporting requirements. The FSOC is also responsible for determining whether a nonbank financial company should be supervised by the Federal Reserve Board and subject to prudential standards, and for designating financial market utilities and payment, clearing, or settlement activities that are, or are likely to become, systemically important. On April 3, 2012, the FSOC unanimously approved a final rule and interpretive guidance that details the process and analytical framework for evaluating whether a nonbank financial company should be subject to supervision by the Federal Reserve Board and be subject to enhanced prudential standards (including the requirement to prepare resolution plans). On May 22, 2012, the FSOC adopted procedures governing the conduct of hearings in connection with proposed determinations and other related actions under Titles I and VIII of the Act. Additionally, on May 22, the FSOC voted to propose the preliminary designation of an initial set of financial market utilities. After those entities are provided with an opportunity for a hearing, the FSOC will be asked to vote on the final designation of those entities.

The Volcker Rule. The Dodd-Frank Act requires the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission and the Federal

banking agencies to adopt regulations generally prohibiting proprietary trading and certain acquisitions of interest in hedge funds or private equity funds.

Last November, the FDIC, jointly with the Federal Reserve Board, the OCC, and the SEC, published a notice of proposed rulemaking (NPR) requesting public comment on a proposed regulation implementing the Volcker Rule requirements of the Dodd-Frank Act. In December, the comment period was extended to allow interested persons more time to analyze the issues and prepare their comments, and to facilitate coordination of the rulemaking among the responsible agencies.

The proposed rule also requires banking entities with significant covered trading activities to furnish periodic reports with quantitative measurements designed to help differentiate permitted market-making-related activities from prohibited proprietary trading. Under the proposed rule these requirements contain important exclusions for banking organizations with trading assets and liabilities less than $1 billion, and reduced reporting requirements for organizations with trading assets and liabilities of less than $5 billion. These thresholds are designed to reduce the burden on smaller, less complex banking entities, which generally engage in limited market-making and other trading activities.

The Agencies have requested comments on whether the proposed rule represents a balanced and effective approach in implementing the Volcker provision or whether alternative approaches exist that would provide greater benefits or implement the statutory requirements with fewer costs. The FDIC is committed to developing a final rule that meets the objectives of the statute while preserving the ability of banking entities to perform important underwriting and market-making functions, including the ability to effectively carry out these functions in less-liquid markets. Most community banks do not engage in trading activities that would be subject to the proposed rule.

Implementation of the Dodd-Frank Act: Community Banks

In addition to the provisions relevant to systemic risk, the Dodd-Frank Act also contains a number of other provisions that may have a more direct effect on community institutions. For example, the Dodd-Frank Act made changes to the FDIC's deposit insurance program, which were implemented soon after enactment, that generally work to the benefit of community institutions. The first of these was the rule to implement the Act's provision to permanently increase the insurance coverage limit to $250,000, the level that had already been introduced on a temporary basis during the crisis. The FDIC has also implemented the Dodd-Frank Act requirement to redefine the base used for deposit insurance assessments as average consolidated total assets minus average tangible equity. This change in the assessment base shifted some of the overall assessment burden from community banks to the largest institutions, which rely less on domestic deposits for their funding than do smaller institutions—but did so without affecting the overall amount of assessment revenue collected. The result has been a sharing of the assessment burden that better reflects each group's share of industry assets. When this provision was implemented in the second quarter of last year, aggregate premiums paid by institutions with less than $10 billion in assets declined by approximately 33 percent, primarily as a result of the base change.

As of March 31, 2012, the Deposit Insurance Fund (DIF) reserve ratio stood at 0.22 percent of estimated insured deposits, up from -0.02 percent a year earlier. The Dodd-Frank Act raised the minimum reserve ratio for the DIF from 1.15 percent to 1.35 percent, and requires that the reserve ratio reach 1.35 percent by September 30, 2020. The FDIC is currently operating under a DIF Restoration Plan that is designed to meet this deadline. However, the Dodd-Frank Act also specifically requires the FDIC to provide an offset to institutions with total consolidated assets of less than $10 billion to relieve them of the extra cost of increasing the reserve ratio from 1.15 percent to 1.35 percent.

A number of community bankers have expressed specific concerns about certain Dodd-Frank Act requirements that they believe would particularly impact them. For example, a number of community bankers have expressed concerns about the provisions of Title XIV that deal with real estate appraisal activities. The Federal Reserve Board implemented these provisions by an interim rule in late 2010 that prohibits coercion or conflicts of interest that could compromise the independent judgment of appraisers and prohibits the extension of credit if coercion or conflicts of interest are suspected to have influenced an appraisal. The banking agencies followed by issuing joint guidance describing supervisory expectations for appraisals under the new rules. The guidelines clarify standards for the appropriate use of analytical methods, the criteria for selecting appraisers, and the independence of the appraisal process. Under the guidelines, institutions also are responsible for moni-

toring and periodically updating valuations of collateral for existing real estate loans and for transactions, such as modifications and workouts.

The banking agencies have received a number of formal and informal communications from bankers citing concerns about the new appraisal guidelines. Of particular concern are the requirements to update valuations for existing real estate loans. This is deemed a best practice for evaluating and monitoring the risk of loans. However, the agencies clarified in the guidance that working with the borrower, particularly as the recovery takes hold, is encouraged. To that end, if no new funds are advanced in a modification, a formal appraisal is not required.

The agencies are still in the process of writing proposed rules for higher risk mortgages and proposed rules for automated loan valuations and registration requirements for the appraisal management companies. The agencies are aware of the potential impact these rulemakings could have on the industry and have met with small business representatives and other industry segments in advance of writing the rules to hear their concerns firsthand. The agencies strongly encourage the public to comment on the proposed rules when they are issued for comment.

Another area of concern for community bankers is the new mortgage escrow requirement. The wave of subprime and nontraditional mortgage lending that led to the crisis frequently included loans where escrow accounts for property taxes and insurance were not maintained. The failure to set aside funds in escrow has been cited as contributing to the financial distress of borrowers when their loans became delinquent. Accordingly, the Dodd-Frank Act directed the Federal Reserve Board to issue new proposed rules that require the establishment of escrow accounts for many closed-end first and second mortgage loans, expand the minimum mandatory period for escrow accounts, and establish new disclosure requirements in this area.

While the new rule directly addresses one of the structural weaknesses in the risky loans that led to the crisis, community bankers have expressed concerns about applying these same requirements to what they say are lower-risk mortgage loans that they hold in portfolio. In many cases, bankers say they hold too few such loans or loans of such small size that the fixed cost of setting up an escrow account would be prohibitive—and they would cease originating such loans for their customers. We have shared the concerns we have heard from community bankers with the Consumer Financial Protection Bureau and they are expected to issue a final rule on this topic later this year.

FDIC Community Banking Initiatives

During a period with significant economic challenges and many regulatory changes, it is natural for community bankers to reflect on their future role in the financial marketplace. As noted above, many community bankers have expressed concerns that the Dodd-Frank Act reforms will adversely affect their ability to compete with larger banks and nonbank competitors. The FDIC takes these concerns seriously. As the lead Federal regulator for the majority of community banks in the United States and the insurer of all, it is incumbent on us to better understand the role of community banks in our economy and the particular challenges they face in the financial marketplace.

This is why the FDIC is undertaking a series of initiatives related to the future of community banks. We began this effort with a conference at our Arlington, Virginia training facility in February, where we received a great deal of useful input on the regulatory and competitive challenges currently facing the industry. We are also in the process of holding a series of roundtables with groups of community bankers in each of the FDIC's six regions around the country. At these roundtables, I am joined by the FDIC's senior executives for supervision so that we can hear first-hand about the concerns of bankers and what the FDIC can do to respond to those concerns. The roundtables are proving to be productive and frank discussions. In my experience, community bankers are not shy about expressing their views, and we appreciate receiving their ideas and input.

Even with all the attention community banking issues have received in recent years, there remains a need for more thoughtful and careful research and analysis about the role that community banks play in the U.S. financial system. As part of our initiative, the FDIC's Division of Insurance and Research also is undertaking a comprehensive review of the evolution of community banking in the United States over the past 25 years. Our hope is that this study will identify the key challenges facing community banks as well as stories of successful community bank business models and will provide an analysis that may be useful for community banks going forward.

Additionally, I have asked the Directors of the FDIC's Division of Risk Management Supervision and Division of Depositor and Consumer Protection to review the examination process for both risk management and compliance supervision, as well

as to review how we promulgate and release rulemakings and guidance, to see if we can improve our processes and communications in ways that benefit community banks, while maintaining our supervisory standards.

Amid the challenging economic conditions of the past few years, the FDIC's examination program has continued to strive for a balanced approach. During each bank examination, our supervisory staff conducts a fact-based review of an institution's financial risk, the quality of its assets, and conformance with bank regulations. Care is taken to ensure national consistency. We make sure that examiners follow prescribed procedures and FDIC policy through our national training program and commissioning process, through internal quality reviews, and with ongoing communication at every level of our supervision staff.

In addition, we also strive to ensure that our examiners understand and follow the FDIC's policies with regard to lending to creditworthy borrowers. The FDIC has adopted supervisory policies and issued several directives that encourage the institutions to lend to creditworthy borrowers. We recognize that safe and sound banking is not an end in itself but a means to an end, which is to ensure that FDIC-insured institutions can be consistent sources of credit for our economy across the business cycle.

Trading Losses at JPMorgan Chase

The recent losses at JPMorgan Chase revealed certain risks that reside within large and complex financial institutions. They also highlighted the significance of effective risk controls and governance at these institutions. As the deposit insurer and backup supervisor of JPMorgan Chase, the FDIC staff work through the primary Federal regulators to obtain information necessary to monitor the risk within the institution. The FDIC is currently working with JPMorgan Chase's primary Federal regulators, the OCC and the Federal Reserve System, as well as the institution itself, to investigate both the circumstances that led to the losses and the institution's ongoing efforts to manage the risks at the firm. Following this review, we expect to work with the primary regulators to address inadequate risk management practices that are identified.

Conclusion

Significant progress has been made in implementing the financial reforms authorized by the Dodd-Frank Act. The FDIC has completed the core rulemakings for carrying out its lead responsibilities under the Act regarding deposit insurance and systemic resolution.

Successful implementation of the Act will provide a foundation for a financial system that is more stable and less susceptible to crises, and a regulatory system that is better able to respond to future crises.

PREPARED STATEMENT OF RICHARD CORDRAY

DIRECTOR, CONSUMER FINANCIAL PROTECTION BUREAU

JUNE 6, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today as part of this panel of my colleagues. As the Director of the Consumer Financial Protection Bureau, I am committed to being accountable to you for how we carry out the laws that Congress enacted, and we are always happy to have the chance to discuss our work with you. This is the 18th time that the Bureau has testified before either the House or the Senate, and I am pleased to be here with you again today. My testimony will focus on the areas that you specified in the letter inviting me to testify at this hearing.

To begin with, you asked about our Bank Supervision program. Since certain supervisory powers were transferred to us in July of 2011, and even before that time, we have been focused on recruiting and hiring the best team we could find to carry out our role in supervising financial institutions with a singular focus on consumer protection. We are blessed with great talent: Steve Antonakes, the former Superintendent of Banks in Massachusetts, heads up our Bank Supervision team; Peggy Twohig, formerly the Associate Director of the Division of Financial Practices at the FTC, heads up our Nonbank Supervision team. Our examiners evaluate products, services, policies, and practices to ensure compliance with Federal consumer financial laws, and to address any harm to consumers that may be resulting from violations of those laws. If a company is not complying with the law, we may seek corrective actions to strengthen its programs and processes, redress violations, and remediate any harm consumers may have suffered.

We have met with many supervised institutions to obtain a better understanding of how they operate and how they approach compliance. We have been engaged with our prudential and State regulator partners to ensure open lines of communication and information sharing. As the law contemplates, we have been coordinating the logistics of simultaneous examinations with our fellow agencies to reduce compliance burden for financial institutions. The Bureau has recruited and hired examiners all across the country, reporting through our four regional offices—covering the Northeast, Southeast, Midwest, and West. We have commenced examination work in all four regions. For the largest and most complex banks and credit unions in the country, the Bureau is implementing a year-round supervision program customized to address the consumer protection risk profile of the organization. For other companies that we supervise, we are conducting periodic examinations and other reviews as appropriate.

To ensure that our work is transparent, we published our Examination Manual, along with other examination procedures covering particular products and services. In order to implement a consistent approach, CFPB examiners examine both banks and nonbanks, and use the same examination procedures for the same products and services. That means the mortgage servicing procedures that we published last October cover both bank and nonbank mortgage servicers, and the mortgage origination procedures we published in January guide our examiners reviewing bank and nonbank originators. Likewise, our short-term, small-dollar lending procedures will be used to examine payday loans made by nonbanks and deposit advance products offered by banks, because these products have many of the same characteristics. As such, they should be reviewed using a consistent set of procedures. Consistency, however, does not dictate complete uniformity in supervisory expectations. Large, complex entities may well have different compliance oversight and management systems than much smaller entities or those offering a more limited number of products and services.

Our responsibility under the law, which is unique among the Federal regulators, is to accomplish evenhanded and reasonable oversight of both banks and nonbank institutions that compete in the consumer finance markets. Last July, we assumed authority to supervise depository institutions with assets of more than $10 billion, and their affiliates, for compliance with Federal consumer financial laws. In January of this year, with the appointment of a Director, we rolled out our nonbank supervision program, starting with nonbank mortgage originators, mortgage servicers, and payday lenders. There are tens of thousands of nonbank firms, and their products affect virtually every American. For example, according to studies and industry sources, nonbank lenders originated almost 2 million mortgages in 2010, nearly 20 million consumers used payday loans, over 30 million people are being pursued by debt collectors, and roughly 200 million Americans rely on credit reporting agencies to report their credit histories accurately.

When considering whether and how to supervise particular nonbanks, the Dodd-Frank Act requires the CFPB to consider several relevant factors, including the nonbank's volume of business, the risks to consumers created by the provision of products and services, and the extent of State oversight. Through our oversight, we are working to level the playing field and make sure these businesses are being held accountable for their actions. We are now considering finalizing a regulation to allow us to examine the larger participants in the debt collection and credit reporting industries, and others will follow as we develop our Nonbank Supervision program. A market in which all competing firms play by the same rules will be of special benefit to community banks, which may operate in similar product markets as nonbank entities.

On Monday, the CFPB and the prudential regulators released a Memorandum of Understanding that clarifies how the agencies will coordinate their supervisory activities, consistent with the Dodd-Frank Act. This MOU establishes arrangements for coordination and cooperation, to minimize unnecessary regulatory burden, avoid unnecessary duplication of effort, and decrease the risk of conflicting supervisory directives.

We welcome feedback on our supervision program from each of you, and from consumer groups, industry participants, and members of the public. We have an e-mail address on our Web site, CFPB__Supervision@CFPB.gov, where anyone can submit comments on our exam procedures.

Second, among the topics you identified to be addressed at this hearing is my statutory role on the Financial Stability Oversight Council. As you know, in the Dodd-Frank Act the Congress designated the Director of the CFPB to serve as one of the 10 voting members of the FSOC. The U.S. consumer finance marketplace represents over $20 trillion in loans and deposits, and hence is central to the stability of domes-

tic and global capital markets. We are pleased to participate in that capacity, and to bring a consumer-facing focus to our work on that body.

Because we share the responsibility of regulating financial institutions with many of our fellow members of the FSOC, our mutual participation is helpful to our efforts to coordinate with one another so as to reduce overall regulatory burden and to maintain a collaborative approach to the work we do together. Frequent and sustained interactions among fellow regulators are essential for each of us to fulfill our obligations and improve the effectiveness of our joint oversight of the financial system. The work we are doing together on the FSOC also helps lift our perspective out of the day-to-day work each of us is doing so as to develop a broader vantage point on the various factors that pose larger risks to the entire financial system taken in the aggregate. I have found this to be valuable as we work together to build a sound and vibrant financial system that protects consumers, supports responsible providers, and helps safeguard the broader economy against systemic risk.

Third, you also indicated that my testimony should address how our statutory obligations affect our regulation of community banks. As you know, the Consumer Bureau generally does not examine any banks with less than $10 billion in assets and does not enforce the law against any such banks, which remain subject to their existing prudential regulator in those respects. We do have the authority to adopt regulations that can affect community banks as well as larger financial institutions, and in this regard we understand it is important for us to coordinate closely with my colleagues on this panel, who will continue to examine and enforce various regulations that we formulate. For this reason, we are creating a consultative rulemaking process with the other agencies to ensure that we develop rules that are consistent with the objectives and obligations of the prudential regulators and other agencies. We have already convened meetings to work cooperatively on issues like overdraft protection and mortgage servicing, and we are consulting with them as we devise the various mandated rules on the mortgage market that Congress has directed us to complete by early next year.

In this respect, it is critical to keep in mind that Congress created the Consumer Financial Protection Bureau in response to the greatest financial crisis since the Great Depression. The United States learned—or relearned—a hard lesson in that crisis: unregulated or poorly regulated markets destabilize the economy and undermine the general welfare. Over-regulation can indeed stifle entrepreneurship, but under-regulation can also lead to terribly antibusiness results. The most mortal threat to many banks, thrifts, and credit unions in our lifetime was dramatically posed by the extreme credit crunch and freezing-up of the financial markets in 2008. In their wake, the ensuing financial meltdown and the enduring consequences of the deep recession continue to dog our economy, particularly the housing market, now 4 years later and counting.

What will be very helpful to community banks around the country is our new mandate to oversee and regularize the practices of nonbank financial institutions that often compete in the same markets. We hear much favorable comment from the community banks about this important task. We saw with the meltdown in the mortgage market how a partial and incomplete regulatory scheme was doomed to fail. Banks, thrifts, and credit unions were subject to explicit oversight, whereas many other mortgage market participants, such as lenders and brokers and originators, were held to little or no standards of accountability at all. The competitive pressure fostered by this regime stimulated a race to the bottom to capture market share. Regulatory arbitrage through charter choice placed further pressures on the system that impeded its effectiveness. The result was a kind of Gresham's Law for financial regulation: the bad practices drove out the good.

I have heard stories from many community bankers who refused to make ill-considered loans to prospective customers, only to see those people go down the street and get that very loan from someone else who did not uphold the same standards. That other lender often required no documentation of income or assets, engaged in no form of recognizable underwriting, but still managed to sell those bad loans into the secondary market. There they were bundled into securities that eventually crashed the entire financial system and with it the broader economy.

Consistent application of consumer financial laws will promote safety and soundness of supervised entities. Over the next year, the Bureau is required to adopt new mortgage rules that protect consumers. These include a new statutory requirement that lenders make a good faith and reasonable determination that borrowers have the ability to repay a residential mortgage loan. Similarly, ensuring that consumers receive required disclosures to help them understand financial products and make informed decisions will help prevent some of the problems we saw in the run-up to the crisis. Other rules are intended to return to sound underwriting standards and

sound customer service—the kind of practices that are traditional at our good community banks.

As we develop these initiatives, we know that one size does not fit all. Where it makes sense to treat smaller institutions differently from larger institutions, we have pledged to consider doing so. We also want our regulations to be more accessible, and to find ways to work with institutions to implement regulations successfully and in ways that will help minimize the burdens of properly complying with the law. To ensure that our rulemaking process is transparent and that we have the benefit of informed comments from a wide variety of stakeholders and the public, the Bureau's regulatory agenda and proposed rules are published on our Web site at *www.ConsumerFinance.gov/regulation*. We are implementing small business review panels on several of our mortgage rules, and find the input from small providers to be helpful in calibrating our proposals.

As we think about systemic risks to the financial system, I would note that the financial world that today's consumers are navigating has become more complex in recent years. The failure to navigate that world successfully can lead to poor choices being made, especially about life-changing decisions that people may confront only once or twice in their lifetimes. When decisions like how to finance an education or a home purchase do not work out well, that can spell disaster for entire families and alter the trajectory of people's opportunities. When this is happening on a large scale, the resulting dislocation can become a trigger for instability, given the trillions of dollars that are represented by loans and deposits in consumer finance markets.

Clear and accurate disclosures benefit the public and the markets by driving competition based on informed customer choice. We have launched several "Know Before You Owe" projects, all of which are pushing to make costs and risks clear up front for consumers. Our signature "Know Before You Owe" mortgage project is focused on simplifying and streamlining the conflicting mortgage forms that reflected no functional need or reality other than the fact that multiple Government agencies were involved. These forms have been confusing homebuyers and burdening industry for many years—an all-too-common occurrence in the realm of consumer finance—and we are taking head-on the responsibility to effect meaningful change in this area.

We are eager to explore alternatives to compulsory regulations where we can make alternatives work. We are collaborating with the industry on a new approach to credit card disclosures. We released a prototype credit card contract that is significantly shorter and clearer than current credit card agreements. We tried to keep the prototype simple and written in plain language to make it accessible to as many consumers as possible. This prototype is now being piloted at the Pentagon Federal Credit Union, and we are spurring similar efforts by other leading financial institutions. More and more of them appear to be recognizing the value for their customers in consumer-friendly information that is more accessible. We wholeheartedly agree.

By working closely with the Department of Education, we have also created a "Financial Aid Shopping Sheet." The Shopping Sheet presents young people and their families with a uniform, easy-to-understand explanation of the total cost of post-secondary education and the available options for financing it. We followed that by launching the "Financial Aid Comparison Shopper". The Comparison Shopper builds on the Shopping Sheet by helping students to compare—in an online, side-by-side format—information about the cost of different schools and how their decisions will affect the level of debt they can expect to incur.

We see financial education and disclosure as a way to help close the gap between consumers' financial capability and where they need to be to navigate consumer finance markets successfully. We can close that gap in two distinct ways: by striving to elevate people's capacity to handle personal finance matters, and by reducing unnecessary complexity in the information provided in that marketplace. And we are actively pursuing both approaches. The work we do in our specialty offices prescribed by Congress, such as our Office of Servicemember Affairs, Office of Older Americans, and Student Loan Ombudsman, also is crucial to understanding and meeting the particular needs of consumers who deserve protection across the country and—as pertains to servicemembers—around the globe.

When I became Director of the Consumer Bureau at the beginning of the year, I barely knew my colleagues on this panel. Now, 5 months later, from our work together in various roles on various bodies such as FSOC, I have come to know and respect them all. Our team is glad to be working with their teams—and with the Members of this Committee—to strengthen and support a sound and vibrant financial system that serves both the interests of consumers and the long-term foundations of the American economy. I am happy to answer any questions you may have.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM DANIEL K. TARULLO

Q.1. During the June 6th hearing, Mr. Gruenberg agreed that "historically, including to the present day, the biggest risk of banking is the lending activity that is inherent to the banking process."

In testimony before the Subcommittee on Financial Institutions and Consumer Protection on May 9th, the former Chief Economist of the Senate Committee on Banking, Housing, and Urban Affairs stated:

> In a remarkably understated 2007 annual inspection report on Citigroup, the Federal Reserve Bank of New York observed that "[m]anagement did not properly identify and assess its subprime risk in the CDO trading books, leading to significant losses. Serious deficiencies in risk management and controls were identified in the management of Super Senior CDO positions and other subprime-related traded credit products." By the end of 2008 Citigroup had written off $38.8 billion related to these positions and to ABS and CDO securities it held in anticipation of constructing additional CDOs. [Testimony of Marc Jarsulic, Chief Economist, Better Markets, Inc., before the Senate Committee on Banking Housing and Urban Affairs Subcommittee on Financial Institutions and Consumer Protection, "Is Simpler Better? Limiting Federal Support for Financial Institutions", May 9, 2012.]

According to accounts of the hearings held by the Financial Crisis Inquiry Commission, two witnesses agreed that CDOs were responsible for Citigroup's financial difficulties:

> [Former Citigroup chief executive Charles] Prince ultimately blamed much of Citi's problems on CDOs, which he said were complex and entirely misunderstood. He said the company, its risk officers, regulators and credit rating agencies believed CDOs were low-risk activities. As it turned out, they resulted in $30 billion worth of losses . . .
>
> [Former Comptroller of the Currency John] Dugan, too, put much of the blame on CDOs, partly as a way of defending his own agency. He said the bank, which the Office of the Comptroller of the Currency oversaw, did not damage the holding company, while Citi's securities broker-dealers, which managed the CDOs and were overseen by the Securities and Exchange Commission, were at fault.
>
> "The overwhelming majority of Citi's mortgage problems did not arise from mortgages originated by Citibank," Dugan said. "Instead, the huge mortgage losses arose primarily from the collateralized debt obligations structured by Citigroup's securities broker-dealer with mortgages purchased from third parties."—Cheyenne Hopkins, "No One Was Sleeping as Citi Slipped", *Am. Banker,* Apr. 8, 2010.

Do you agree with the New York Fed, the former Comptroller of the Currency, the former Chief Economist of the Senate Banking

Committee, and the former CEO of Citigroup that CDOs were a substantial cause of Citigroup's financial difficulties in 2008, resulting in significant support from the Federal Government, including capital injections from the Treasury Department, debt guarantees from the FDIC, and loans from the Federal Reserve?

A.1. Although information regarding examinations of banks and bank holding companies is protected by law, testimony before the Senate Banking Committee, as you note, disclosed that management of Citigroup did not properly identify, monitor, and assess the risk of certain CDO positions in its portfolio. The SEC reported that by September 2007 Citigroup amassed a position in asset-backed security CDOs in excess of $50 billion. Between the third quarter of 2007 and the first quarter of 2009, Citigroup reported losses on "subprime related direct exposures" of approximately $35 billion, the majority of which was attributed to this CDO position.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM DANIEL K. TARULLO

Q.1. At what point in the process of JPMorgan making this trade and the public reporting of the losses did the Fed examiners become aware of this trade?

A.1. See response to Question 2.

Q.2. Precisely when were Fed regulators aware of this trade?

A.2. JPMorgan Chase publicly announced in May 2012 that it had suffered significant trading losses on credit derivative positions entered into by its Chief Investment Office (CIO). The CIO is an organizational unit of JPMorgan Chase, N.A., that carries out a variety of asset-liability management and other activities. The activities of the CIO are managed and controlled out of JPMorgan Chase's New York headquarters, with a substantial portion of the CIO's activities conducted through the bank's London branch and other overseas branches or offices.

The Federal Reserve, in its capacity as JPMorgan Chase's holding company supervisor, first discussed the losses on the trades in the CIO with JPMorgan Chase's senior management in the first half of April 2012.

Q.3. How many trades does JPMorgan have of this magnitude and what are the possibilities, given Europe and a softening domestic economy, that a number of these bets go bad at the same time?

A.3. JPMorgan Chase has admitted that it did not have appropriate risk management processes in place to monitor the risk of its trading activities. As indicated in the response to Question 4, the Federal Reserve is working with JPMorgan Chase and the OCC to address these risk management failures. Confidential information regarding specific positions held by a bank holding company and examinations of bank holding companies, such as JPMorgan Chase, are protected by law.

Q.4. Does the Fed examine each of these trades as they occur? If not, how does the OCC monitor the risk that the bank it supervises is undertaking?

A.4. The trading losses suffered by the CIO arose out of a complex synthetic credit portfolio that the CIO had developed over time, which was primarily composed of both long and short credit default swap positions on a number of different credit assets and indices. Trading in this synthetic credit portfolio was executed through the London branch of JPMorgan Chase's subsidiary national bank. JPMorgan Chase has stated that, because of a combination of risk-management failures and execution errors, and the complexity and illiquidity of the positions involved, the CIO's synthetic credit portfolio gave rise to significant trading risks that resulted in the losses.

The Federal Reserve—in its capacity as consolidated supervisor of the bank holding company—is working with the OCC to review the firm's response and remedial actions. In particular, the Federal Reserve has been assisting in the oversight of JPMorgan's efforts to manage and de-risk the portfolio in question. As this process proceeds, the Federal Reserve anticipates that it would also work with the OCC and FDIC to identify the changes in risk measurement, management and governance that will be necessary to improve risk-control practices surrounding the firm's trading activities and to address trading strategies that led to these losses.

In addition, the Federal Reserve has been looking at other parts of the holding company to determine if governance, risk management and control weaknesses—similar to those exposed by this incident—are present elsewhere. While we have, to date, found no evidence that they are, this review is not yet complete.

Q.5. If regulators are focused on regulating risk management practices, and not focused on individual trades regardless of size, would the regulators and the banking system would be safer and better off if the larger banks were required to hold more capital than regional or community banks?

A.5. The trading losses at JPMorgan Chase have served to remind us of the fundamental importance of capital regulation in our prudential oversight of the largest banking firms to ensure that capital is available to absorb all kinds of losses. For precisely this reason, the Federal Reserve has been a strong advocate for higher and better quality capital at the largest and most complex banking organizations. Crucially, the Federal Reserve through the Supervisory Capital Assessment Program, Comprehensive Capital Analysis and Review (CCAR), and its supervisory efforts has encouraged the large banking firms to increase their tier 1 common ratio, which compares high-quality capital to risk-weighted assets, by more than double during the past 3 years to a weighted average of 10.9 percent from 5.4 percent in the first quarter of 2009. The Federal Reserve has also worked both nationally and internationally to improve and increase capital positions at large banking firms. In the United States, the Federal Reserve has worked with the other Federal banking regulators to take important steps to strengthen bank capital regulation, especially for the largest, most complex banks. Over the past several months, the Federal Reserve, OCC, and FDIC have acted jointly to finalize U.S. implementation of the so-called Basel 2.5 reforms that will materially strengthen the market risk capital requirements of Basel II. We have also requested pub-

lic comment on changes to the U.S. regulatory capital rules to implement the Basel III reforms and the capital requirements in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The proposed changes would improve the quality and quantity of regulatory capital held at our Nation's banking organizations. Importantly, many of these regulatory reforms specifically address and strengthen the capital requirements applicable to trading activities and positions, including complex derivatives.

The Federal Reserve has also advocated internationally for capital surcharges on the world's largest, most interconnected banking organizations based on their global systemic importance. Last year, an international agreement was reached on a framework for such surcharges, to be implemented over a 2016–19 transition period. This initiative is consistent with the Federal Reserve's obligation under section 165 of the Dodd-Frank Act, 12 U.S.C. 5365, to impose more stringent capital standards on systemically important financial institutions, including the requirement that these additional standards be graduated based on the systemic footprint of the institution. In December 2011, the Board issued a proposal to implement section 165, including enhanced capital requirements for large bank holding companies, such as JPMorgan Chase, that would require these bank holding companies to meet higher capital requirements than apply to smaller banking organizations. See 77 *Federal Register* 592 (January 5, 2012).

Q.6. Dodd Frank very clearly limits the potential that commercial companies could somehow become regulated like banks. One of the ways it does this is achieved through an amendment that I and Senator Pryor offered, which clearly limits the definition of "financial activities" to those things listed under Section 4(k) of the Bank Holding Company Act. However the Fed has proposed that it can ignore the definition contained in 4(k) and create a separate list of "financial activities" for purposes of Dodd Frank. That is clearly contrary to both the plain language and the intent of our amendment.

A.6. See response to Question 9.

Q.7. As you know section 113 of Dodd-Frank gives the FSOC the authority to designate a company that is intentionally structured to avoid the 85 percent test, and 167 of Dodd-Frank allows the Fed to regulate only a separately set up financial company of an otherwise validly designated NBFC. Neither provision gives the Fed the ability to create its own list.

A.7. See response to Question 9.

Q.8. Can you tell me why the Federal Reserve thinks it can ignore the law in this area, and put commercial companies that were not involved in the financial crisis at risk?

A.8. See response to Question 9.

Q.9. What is the intent of the Federal Reserve's rulemaking in this area if the intent isn't to circumvent the Vitter-Pryor amendment to Dodd-Frank?

A.9. Questions 6 through 9 address the provisions of the Dodd-Frank Act that define the type of firm that is eligible to be designated by the Financial Stability Oversight Council for enhanced

supervision by the Federal Reserve where the Council finds that the firm poses a threat to the financial stability of the United States. These provisions apply only to firms that derive 85 percent or more of their annual gross revenues from financial activities or where 85 percent or more of the firm's consolidated assets are related to financial activities.[1] As you note, for purposes of this provision, financial activities are defined by reference to section 4(k) of the Bank Holding Company Act (BHC Act).[2]

In April 2012, the Board invited public comment on proposed rules implementing these provisions (April 2012 proposal). The proposal would adopt the list of financial activities created under section 4(k) of the BHC Act. The April 2012 proposal also noted that the list of financial activities published by the Federal Reserve in its Regulation Y incorporates various conditions that the Board has imposed on bank holding companies to ensure that bank holding companies that engage in these financial activities do so in a safe and sound manner. Many of these conditions were imposed so that a bank holding company's financial activities did not threaten the safety and soundness of its subsidiary insured depository institution. Other conditions were imposed by the Board because they were required by other provisions of law, such as the Glass-Steagall Act. In each of these cases, the condition was distinct from the definition of the activity itself or the nature of the activity as financial. The April 2012 proposal sought public comment on whether any of the conditions were essential to the definition of an activity as financial.

We appreciate your views, which we will take into consideration in formulating our final rule. We will place your letter in the public comment file for this proposed rule.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM THOMAS J. CURRY

Q.1. Mr. Curry, in response to my question during the hearing about the risk management of JPMorgan Chase & Co. (JPMorgan), you stated that the Office of the Comptroller of the Currency (OCC) is reviewing "what exactly transpired with the trading operation within the CIO's office, and . . . looking to make sure that there were appropriate limits and controls on those activities in that area and how they compared to other areas within the organization." Two weeks later, you stated that "we do believe, as a preliminary matter, that there are apparent serious risk management weaknesses or failures at the bank. We're attempting . . . to continue to examine the root causes for those failures and to determine whether or not there are other weaknesses in the bank besides the CIO."

When do you expect to complete your review? Do you have any further preliminary conclusions on your review of the bank's risk management? What gaps have you identified as supervisors? Please provide additional detail about what you meant by "serious risk management weaknesses or failures at the bank."

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[1] Section 102(a)(6) of the Dodd-Frank Act; 12 U.S.C. §5311(a)(6).
[2] Id.

A.1. Our examination process is well advanced and we expect to reach conclusions and communicate our findings to bank management before the end of the third quarter. Our work will also consider whether any additional remediation is warranted.

At this time our preliminary conclusions regarding the weaknesses or failures that have been identified are consistent with the findings and principal conclusions of the bank's internal task force. In mid-July, 2012 these determinations were publicly communicated:

- The core issue was that CIO was not subjected to the same level of scrutiny as client facing businesses, causing a lack of effective challenge by senior management and the board.
- CIO judgment, execution, and escalation in 1Q12 were poor.
- The level of scrutiny did not evolve commensurate with the increasing complexity of CIO activities.
- CIO risk management was ineffective in dealing with the synthetic credit portfolio.
- Risk limits for CIO were not sufficiently granular.
- Approval and implementation of CIO synthetic credit VaR model were inadequate.

The company is implementing corrective actions. An entirely new CIO senior management group is in place and is undertaking an end-to-end review of all CIO processes and practices. Firm-wide risk management and processes are also being evaluated and new committees and processes are being put in place.

Q.2. How many staff members are ordinarily involved in supervising JPMorgan, especially with regard to the company's risk management, and how many additional staff have you dedicated to this review?

A.2. The OCC's supervisory team includes approximately 65 full time on-site examiners who are responsible for reviewing nearly all facets of the bank's activities and operations, including commercial and retail credit, mortgage banking, trading and other capital markets activities, asset liability management, bank technology and other aspects of operational risk, audit and internal controls, and compliance with the Bank Secrecy Act, antimoney laundering laws, and the Community Reinvestment Act. These on-site examiners are supported by additional subject matter experts from across the OCC. All these examiners are essentially involved in supervising the risk management practices of JPMorgan as risk management systems are in place throughout the bank's operations to identify, measure, monitor, and control risk.

We have one dedicated examiner who directly oversees the CIO with support of a team of capital markets specialists representing 8 FTEs to review specific capital markets areas depending on the topic. We have added staff on assignment from our London team, our Risk Analysis Division (quantitative experts), and received assistance from our Office of Chief Accountant.

Q.3. In testimony, you stated that "in hindsight, if the reporting were more robust or granular, we believe we may have had an inkling of the size and potential complexity and risk of the position."

You also stated before this Committee, that the "concentrated nature of the trading and the illiquidity of [the trading] are red flags that are clearly apparent now."

What requirements or guidelines does the OCC have for granularity of reporting, and what does the OCC plan to require in the future as a result of these events?

A.3. We expect risk reports to accurately present the nature and level(s) of risk taken and compliance with approved limits.

Q.4. What role do concentrations and liquidity of positions play in your assessment of trading risks, and how will the OCC ensure that it can capture such red flags in its supervision?

A.4. We consider both concentrations and position liquidity when we assess trading activities. We expect that risk limits and controls fully address the nature of risks being undertaken. In instances where there is limited market liquidity, or excessive concentrations, we expect limits to address the risk and that appropriate valuation adjustments are made.

Q.5. Please describe how the OCC works with other regulators that may be collecting information that would be helpful in identifying developing risks or problems. Does the OCC work with the Office of Financial Research, for example, in a way to maximize data collection and analysis, across financial agencies in a way that will provide a stronger early warning system?

A.5. OCC is an active member of the Office of Financial Research (OFR) data advisory group. This group is undertaking several initiatives involving data collection involving the financial agencies. The most recent initiatives of this group are the data inventory, and the legal entity identifier projects. For the data inventory project, OFR has completed an inventory of all the financial agencies purchased data and they are working on building a portal to share this inventory with all participating agencies. OCC is also a member of the Financial Stability Oversight Council (FSOC) data subcommittee. The data subcommittee is working to develop a strategy for managing the set of data initially needed by the OFR to monitor and study the financial stability of the Nation's economy.

Q.6. You indicated that because you may not have been given adequate or accurate information by bank management, your supervisory abilities were limited, and that "quality supervision is dependent on the quality of information available to examiners."

What is the role of institution-generated information in your agency's assessment of an institution's risk management? Please describe the process and importance of how your agency independently verifies that any information a company provides is accurate.

A.6. The role of institution-generated information is critical in our assessment of the bank's risk profile and risk management processes. We assess management's process to develop and maintain management information systems (MIS) that will ensure information is timely, accurate, and pertinent. This assessment not only includes the processes to develop and test new MIS, but also the reliability of this information through the bank's quality assurance process at the line of business level and the independent reviews

performed by the bank's risk management and audit functions. We check to confirm that the scope and frequency of these independent reviews include verification procedures for the quality of MIS. In addition, the examiners through ongoing supervision and target examinations perform transactional testing that confirms the accuracy of critical MIS relied upon by bank management and the regulators.

Q.7. You stated before this Committee that "it does not appear that the [OCC] met the heightened expectations" of "strong risk management and audit." Please explain what these heightened expectations are, and what steps you are taking to ensure the OCC meets them.

A.7. My intent was that the bank did not meet the OCC's heightened expectations for strong risk management and audit functions. The OCC sets higher expectations for our large banks as part of our lessons learned from the financial crisis. I described the OCC's heightened expectations in my testimony before the U.S. Senate's Committee on Banking, Housing, and Urban Affairs on June 6, 2012, including comments on strong risk management and audit. We have communicated the importance of meeting these expectations to our large banks and their boards of directors. We are monitoring, evaluating, and discussing with bank management the bank's progress in working towards our heightened expectations. We will use our supervisory tools including informal or formal enforcement actions to ensure each large bank achieves a strong risk management and audit function.

Q.8. At the Committee's hearing where Jamie Dimon, Chairman of the Board, President and Chief Executive Officer of JPMorgan testified, Mr. Dimon indicated that while the company has a compensation claw back policy in place, that authority has not been exercised. For the largest national banks the OCC regulates, are you aware of any bank exercising a claw back of compensation when major mistakes are made? Is it important for Boards of Directors of national banks to utilize their claw back authority to deter other employees from making the same mistakes, and correct some of the misaligned pay incentives we saw leading up to the recent financial crisis?

A.8. We are not aware of the use of claw backs to date in large national banks. As conveyed in the Interagency Guidance on Sound Incentive Compensation Policies (OCC Bulletin 2010-24), the OCC believes boards of directors should use claw back authority under appropriate circumstances. JPMC notified us and subsequently has announced that it plans to claw back compensation from the individuals directly responsible for the CIO losses. The bank's investigation into the matters is ongoing and additional claw backs may be coming. The OCC will review these decisions to ensure they are appropriate.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM THOMAS J. CURRY

Q.1. In the wake of the JPMorgan loss there has been a lot of discussion about hedging activities. Many financial institutions de-

velop hedging strategies with interest rate and credit derivatives to hedge volatility.

What is the oversight process for banks who hedge risk and how are these hedges examined?

How do you determine whether a particular activity is or is not ready "hedging"?

A.1. As banking is a risk-taking business, we fully expect that banks will take actions to reduce or eliminate unwanted risk exposures. Hedging actions can take place on a transaction-by-transaction basis, or on a portfolio basis. Transaction hedging is easier to define and understand as one can see the risk additive transactions being offset by risk reduction transactions.

The concept is the same for portfolio hedging, but the measurement of the correlation between the portfolio of risk and the hedge is more difficult to document, as the hedging instrument is not always the specific offset to the underlying risk. Similar to transaction hedging, we look to understand the nature of the portfolio of risk, how its value changes with price or rate changes. We then look to see how the hedge performs in similar situations. We expect bank reports to document and support a strong negative correlation between the risk position and the hedge.

A hedge position must be offsetting some existing risk exposure. Bank risk reports need to identify the underlying position and document its sensitivity to price or rate movements.

Q.2. Given the complexities identified during the hearing with determining whether or not a trade is a hedge or a proprietary trade, it appears the real issue is whether a trade threatens the safety and soundness of the bank.

How do you determine whether the trade presents risks to the safety and soundness of a bank?

If a trade does present such risks, what authority do you have to stop or prevent the trade from occurring?

A.2. A trade (or trading position consisting of multiple trades) would present risks to the safety and soundness of a bank if the loss exposure materially impacted the earnings and capital of the bank. We evaluate risk measures, position reports, and limits (including VaR and others established to guard against illiquid or concentrated positions) to ensure that the risk appetite is reasonable and would not pose a material threat to earnings or capital. Controls should also be in place and be tested regularly to ensure that risk-takers operate within their limits.

Through the examination process, the OCC will evaluate risk mitigation activities. In the event that we determine inappropriate risk, we will call this to management's attention and require actions to remediate our concerns.

If bank management is not sufficiently responsive, the OCC has a wide-range of supervisory tools that it can use to address an unsafe and unsound position that threatens the bank including a temporary Cease and Desist Order. A temporary Cease and Desist Order is an interim order issued by the OCC pursuant to its authority under 12 U.S.C. 1818(c) and is used to impose measures that are needed immediately pending resolution of a final Cease and Desist Order. Such orders are typically used only when imme-

diately necessary to protect the bank against ongoing or expected harm. A Temporary Cease and Desist Order may be challenged in U.S. district court within 10 days of issuance, but is effective upon issuance and remains effective unless overturned by the court or until a final order is in place.

Q.3. The FDIC has testified today that small bankers have told the FDIC that compliance with the escrow account requirement in Dodd-Frank could be so costly as to be prohibitive, and that they would cease originating mortgage loans for their customers.

Do you agree with the FDIC?

What specific recommendations has the OCC given the Bureau as it develops the final rule implementing the Dodd-Frank escrow requirements?

A.3. While we have not received direct communication from the community banks that we supervise about the potential changes to the escrow requirements, we have received anecdotal reports that indicate some community bankers have concerns about these proposed changes. We are also aware of the comment letters that the Independent Bankers Association of Texas submitted to the Federal Reserve Board and more recently, to the Consumer Financial Protection Bureau (CFPB) on this issue.

Community bankers, however, have expressed concerns to us about the overall cumulative impact that the Dodd-Frank Act may have on their operations. In the area of mortgage lending, for example, the Dodd-Frank Act also directs the CFPB to issue new standards for mortgage loan originators; minimum standards on mortgages themselves; limits on charges for mortgage prepayments; new disclosure requirements in connection with mortgage origination and in monthly statements; a new regime of standards and oversight for appraisers; and a significant expansion of HMDA requirements for mortgage lenders to report and publicly disclose detailed information about mortgage loans they originate. We support strong consumer protections for residential mortgages, but it is also important to recognize that the fixed costs associated with new regulatory requirements have a proportionately larger impact on community banks due to their smaller revenue base. As the OCC has previously testified, a particular concern is whether these and other forthcoming regulations combine to create a tipping point causing banks to exit lines of business that provide important diversification of their business, and increase their concentration in other activities that raise their overall risk profile.

For these reasons, we believe it is important that the OCC and other regulatory agencies seek to implement the Dodd-Frank Act in a manner that accomplishes the legislative intent without unduly harming the ability of community banks to fulfill their role of supporting local economies and providing the services their customers rely on. Over the past year, OCC has engaged in constructive dialogue with the CFPB on a range of supervisory and regulatory matters of mutual concern. As the CFPB rulemaking process moves forward, OCC will continue to participate in the consultative process to ensure that alternatives that lessen the burdens on community banks are considered.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM THOMAS J. CURRY

Q.1. Do you agree with the comments that former Comptroller of the Currency John Walsh made in London at the Center for the Study of Financial Innovation in 2011 to the effect that regulators should not require more capital at our largest banks?

A.1. As I have stated previously to the Senate Banking Committee, I am a strong proponent of increasing both the quantity and quality of the capital reserves held by our financial institutions. Towards that end, I support and continue to move forward with the revisions to capital standards developed by the Basel Committee. The OCC and the other Federal banking agencies recently approved a set of proposed rules and a final rule that move the United States forward in adopting the Basel capital standards often referred to as Basel III.

More specifically, we continue to support the higher capital standards developed by the Basel Committee for systemically important banks, and we are working with the Federal Reserve Board as it develops enhanced prudential standards (including capital) for bank holding companies with over $50 billion in assets as part of the implementation of section 165 of the Dodd-Frank Act.

Q.2. Are there any tools that you need to correct the problems with large trading losses at systemically significant institutions that Congress has not already given you in the Wall Street reform law or that is in other existing authority?

A.2. No. The OCC has appropriate authority to review and assess trading operations conducted within the institutions we supervise, and, if warranted, take appropriate enforcement actions based on those assessments. Our authority includes the ability to access relevant books and records of a bank's trading activities and its associated policies, procedures, and controls to manage those risks. We likewise have an array of tools that we can use to compel corrective action, ranging from Matters Requiring Attention to formal cease and desist orders.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM THOMAS J. CURRY

Q.1. During the June 6th hearing, Mr. Gruenberg agreed that "historically, including to the present day, the biggest risk of banking is the lending activity that is inherent to the banking process."

In testimony before the Subcommittee on Financial Institutions and Consumer Protection on May 9th, the former Chief Economist of the Senate Committee on Banking, Housing, and Urban Affairs stated:

> In a remarkably understated 2007 annual inspection report on Citigroup, the Federal Reserve Bank of New York observed that "[m]anagement did not properly identify and assess its subprime risk in the CDO trading books, leading to significant losses. Serious deficiencies in risk management and controls were identified in the management of Super Senior CDO positions and other subprime-related traded credit products." By the end of 2008 Citigroup had

written off $38.8 billion related to these positions and to ABS and CDO securities it held in anticipation of constructing additional CDOs. [Testimony of Marc Jarsulic, Chief Economist, Better Markets, Inc., before the Senate Committee on Banking Housing and Urban Affairs Subcommittee on Financial Institutions and Consumer Protection, "Is Simpler Better? Limiting Federal Support for Financial Institutions", May 9, 2012.]

According to accounts of the hearings held by the Financial Crisis Inquiry Commission, two witnesses agreed that CDOs were responsible for Citigroup's financial difficulties:

> [Former Citigroup chief executive Charles] Prince ultimately blamed much of Citi's problems on CDOs, which he said were complex and entirely misunderstood. He said the company, its risk officers, regulators and credit rating agencies believed CDOs were low-risk activities. As it turned out, they resulted in $30 billion worth of losses . . .
>
> [Former Comptroller of the Currency John] Dugan, too, put much of the blame on CDOs, partly as a way of defending his own agency. He said the bank, which the Office of the Comptroller of the Currency oversaw, did not damage the holding company, while Citi's securities broker-dealers, which managed the CDOs and were overseen by the Securities and Exchange Commission, were at fault.
>
> "The overwhelming majority of Citi's mortgage problems did not arise from mortgages originated by Citibank," Dugan said. "Instead, the huge mortgage losses arose primarily from the collateralized debt obligations structured by Citigroup's securities broker-dealer with mortgages purchased from third parties."—Cheyenne Hopkins, "No One Was Sleeping as Citi Slipped", *Am. Banker,* Apr. 8, 2010.

Do you agree with the New York Fed, the former Comptroller of the Currency, the former Chief Economist of the Senate Banking Committee, and the former CEO of Citigroup that CDOs were a substantial cause of Citigroup's financial difficulties in 2008, resulting in significant support from the Federal Government, including capital injections from the Treasury Department, debt guarantees from the FDIC, and loans from the Federal Reserve?

A.1. Yes. Excessive risk-taking in subprime collateralized debt obligations (CDOs) was a substantial cause of Citigroup's financial difficulties in 2008.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM THOMAS J. CURRY

Q.1. At what point in the process of JPMorgan making this trade and the public reporting of the losses did the OCC examiners become aware of this trade?

A.1. The OCC knew the bank was planning to modify its position; however, we were not fully aware of the manner in which management chose to do that, or the rapid build-up in the size or com-

plexity of the bank's CDS positions in the first quarter of 2012. Bank reports did not initially fully identify and convey measurements of the change in risk, and bank executive management did not understand the full impact of the new exposures. Unexpected losses were first identified in late March. The CEO of the CIO explained that these were an anomaly in market prices and that the market would "mean-revert." Profit and loss volatility increased in early April leading up to the "London Whale" article on April 6, 2012. We spoke with bank management at various times in April and obtained more detailed information on the position as press reports appeared about the bank's positions in the market. At the time, management indicated the situation was managed and under control. We advised bank management to keep us informed and notify us of material changes, and we began discussing additional follow up actions. From that time forward, the losses became larger and the explanation of market anomaly was less viable. On May 4, management contacted the OCC EIC to notify him of the changed assessment and the magnitude of losses realized during the second half of April.

Q.2. Does the OCC examine each of these trades as they occur? If not, how does the OCC monitor the risk that the banks it supervises is undertaking?

A.2. The OCC does not examine individual trades (or loans) as they occur. Our role is not to approve or manage the bank's risk positions. Rather, we assess the bank's risk management and controls over its activities.

Bank management is responsible for managing risks. The OCC focuses on whether a bank has a sound risk management system. A sound program will identify risk, measure risk, monitor risk, and control risk. Through a combination of discussions with management supported by review of board and management reports, examination activities are targeted based on assessment of risk. OCC examiners evaluate policies, procedures, activities and performance. Under this approach, examiners focus on a bank's risk appetite and the limits and controls that are designed and implemented to identify and control the risks they assume.

The OCC recognizes that banking is a business of taking risks in order to earn a profit. However, when risk is not properly managed, the OCC directs bank management to take corrective action. In all cases, the OCC's primary concern is that the bank operates in a safe and sound manner and maintains capital, reserves, and liquidity commensurate with its risk.

Q.3. How many trades does JPMorgan have of this magnitude and what are the possibilities, given Europe and a softening domestic economy that a number of these bets go bad at the same time?

A.3. Trading in these instruments historically occurs primarily in the Investment Bank, where the controls are appropriate for the risk and activity. We do not believe that other such significant positions exist in the company. Stress testing for a variety of stress scenarios occurs regularly, and both European and domestic considerations are among those analyzed.

Q.4. If regulators are focused on regulating risk management practices, and not focused on individual trades regardless of size, would the regulators and the banking system would be safer and better off if the larger banks were required to hold more capital than regional or community banks?

A.4. The OCC supports both the Basel Committee's efforts to require higher capital for systemically important banks and the provisions of the Dodd-Frank Act which require enhanced prudential standards (including capital) for bank holding companies with over $50 billion in assets. Both of these initiatives will lead large banks to hold more capital than regional and community banks.

In addition, the U.S. bank regulatory agencies recently finalized changes to capital standards that apply to banks' trading activities. These changes are consistent with changes made by the Basel Committee to reflect lessons learned during the financial crisis. These enhancements, often referred to as Basel 2.5, should improve the risk sensitivity of capital standards with respect to banks' trading exposures.

While the changes to capital standards represent marked improvements in risk measurement and material increases in capital requirements for large banks, we do not view them as a substitute for, but rather as a complement to, strong supervision and improved bank risk management practices.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM THOMAS J. CURRY

Q.1. When Congress passed the Volcker Rule provisions of the Dodd-Frank Act, Congress intended to give regulators the authority to exclude venture capital funds from the definition of "covered funds." In a recent study, the FSOC recommended "that Agencies carefully evaluate the range of funds and other legal vehicles that rely on the exclusions contained in section 3(c)(1) or 3(c)(7) and consider whether it is appropriate to narrow the statutory definition by rule in some cases."

Do you agree that you have the authority and discretion to exclude venture capital funds from the definition of "covered funds"?

A.1. The agencies are reviewing and carefully considering the many comments we have received on the scope of our authority and discretion to exclude certain funds and other legal vehicles that rely on the exclusions contained in section 3(c)(1) or 3(c)(7) from the definition of "covered fund." Because we are in the midst of this joint rulemaking, we are unable to express our views on the merits of the question you raised or provide interpretive advice on the provisions of section 619. Rest assured, however, that the OCC is committed to working expeditiously with the other regulators to develop a final rule that is consistent with statutory requirements.

As you know, the OCC regulates national banks and Federal thrifts that have limited authority to directly make venture capital investments. The involvement of national banks and Federal thrifts in venture capital investments is limited given the restrictions on their authority to invest in securities under applicable laws and regulations. See 12 U.S.C. §§24 (Seventh) and 1464(c); and 12 CFR Part 1 and 160.30.

However, national banks and Federal thrifts may rely on their small business investment company and public welfare investment authorities to make equity and equity-like venture capital investments. See 15 U.S.C. §682(b); 12 U.S.C. §§24 (Eleventh) and 1464(c)(4)(F). For example, national banks and Federal thrifts each may invest up to specified limits in small business investment companies (SBICs), which are privately owned and managed investment funds licensed by the Small Business Administration (SBA) that can make venture capital investments, and in community development venture capital companies (CDVCs), which operate similarly to an SBIC but without SBA involvement. We note that section 619 expressly preserves the ability of banks and thrifts to invest in SBICs and other public welfare investments of the type permitted under 12 U.S.C. 24 (Eleventh).

Q.2. Do you agree that sound venture capital investments lead to job creation and economic growth?

A.2. While questions related to the impact of specific types of entities on job creation and economic growth are not within the scope of the OCC's mission, the sound deployment of capital is clearly critical to a well-functioning economy.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM MARTIN J. GRUENBERG

Q.1. In recent testimony on the trading loss by JPMorgan Chase & Co. (JPMorgan), you stated that the FDIC's "discussions have also focused on the quality and consistency of the models used in the CIO as well as the approval and validation processes surrounding them." What have you learned about the quality and consistency of the models and the approval and validation processes at JPMorgan?

A.1. The FDIC continues to work with both OCC and Federal Reserve staff to review the models used in JPMorgan Chase's CIO unit for the assessment of risk associated with that unit's credit hybrid's business. This review has focused on an assessment of the JPMorgan Chase's VaR methodology and the identification of any weaknesses in the firm's processes and procedures for model governance, validation, and controls. This evaluation is ongoing and the FDIC does not publicly disclose regulators' findings.

Q.2. You have stated that your agency is in the process of internally reviewing the transactions, including identifying any "potential gaps within the firm's overall risk management." Mr. Curry has additionally stated that the Office of the Comptroller of the Currency (OCC) will be assessing how it can improve supervisory processes at the OCC. What gaps have you identified at the bank and as supervisors?

A.2. Along with the OCC and the Federal Reserve, the FDIC continues its evaluation of the CIO portfolio, its governance structure, and the results of the work performed by JPMorgan Chase's internal investigation. The firm has identified major gaps in several areas within the CIO business line that contributed to the losses incurred. The primary areas of focus for the firm include the CIO trading strategy, VaR methodology and model governance, strength

of risk management, and the CIO limit structure/escalation process.

Q.3. You also stated in recent testimony, that the FDIC has added temporary staff to assist in its review. How many staff members have been hired, and do you have any updates on the FDIC's review?

A.3. The FDIC has a permanent staff of four professionals on-site at JPMorgan Chase. Three additional FDIC staff members have been engaged to focus on the analysis of CIO related issues in addition to the analytical support of other FDIC examiners on an ad hoc basis.

Q.4. At the Committee's hearing where Jamie Dimon, Chairman of the Board, President and Chief Executive Officer of JPMorgan testified, Mr. Dimon indicated that while the company has a compensation claw back policy in place, that authority has not been exercised. For the largest banks that benefit from the $250,000 deposit insurance guarantee, are you aware of any bank exercising a claw back of compensation when major mistakes are made? Is it important for Boards of Directors of a large bank to utilize their claw back authority to deter other employees from making the same mistakes, and correct some of the misaligned pay incentives we saw leading up to the recent financial crisis?

A.4. JPMorgan Chase announced during its second quarter earnings release that the firm intended to claw back compensation from CIO managers in London responsible for the CIO Synthetic Credit Portfolio. These employees were terminated without a severance or 2012 incentive compensation and the firm imposed the maximum claw back amount of 2 years of annual compensation. In one instance, an employee volunteered the claw back; and all claw back decisions were reviewed by JPMorgan Chase's Board of Directors. A firm's board of directors should be involved in the application of claw back provisions; and in the JPMorgan Chase situation, it appears that senior management took action without prompting from the Board.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM MARTIN J. GRUENBERG

Q.1. You testified today that small bankers have told the FDIC that compliance with the escrow account requirement in Dodd-Frank could be so costly as to be prohibitive, and that they would cease originating mortgage loans for their customers. What specific recommendations have you given the Bureau as it develops the final rule implementing the Dodd-Frank escrow requirements?

A.1. As you know, the FDIC is the primary Federal regulator for the Nation's small community banks. My staff engages frequently with community banks in roundtables around the country to be certain that we understand how regulatory changes affect them and to listen to their concerns. We know that in many rural and underserved areas, community banks are the primary source to meet the financial services needs in those communities.

We understand that the Dodd-Frank Act's mandatory escrow accounts do not apply to all mortgage lending. The requirement does

not apply to market-rate loans that are not insured by a Government agency, unless State or Federal law provides otherwise. [1] Additionally, the Dodd-Frank Act allows the Bureau to exempt banks and other lenders operating in rural or underserved areas from the escrow requirements.

Prior to the implementation of the CFPA (Consumer Financial Protection Act of 2010) and the Consumer Financial Protection Bureau's start-up date, the Federal Reserve Board issued a notice of proposed rulemaking that would amend the existing escrow rule to reflect the Dodd-Frank Act changes. [2] As of July 21, 2011, this proposal became a CFPB proposed rule.

The proposed rule contemplated an exemption for creditors in rural and underserved areas. We have shared with the CFPB the feedback we have received from community banks, particularly those in rural areas, regarding the banks' concerns about the impact of the proposed escrow rule, and we have suggested that the Bureau exempt from the escrow requirement all banks that operate predominantly in rural areas.

We will continue to explore options to improve the examination process for community banks while preserving the benefits of appropriate regulation that ultimately will serve the interest of lenders, consumers, and the economy as a whole. We will continue to offer to the Bureau the perspective we bring as a result of our commitment both to the health and continued vibrancy of small community banks and to the needs of the customers they serve.

Q.2. Mr. Gruenberg, in a recent speech you said that the failure of a systemically important financial institution will likely have significant international operations and that this will create a number of challenges. What specific steps have been taken to improve the cross-border resolution of a SIFI?

A.2. The following specific steps have been taken to improve the cross-border resolution of a SIFI:

- *Identification of Priority Jurisdictions:* The FDIC has conducted a series of "heat map" exercises with respect to the global footprint of U.S. SIFIs to identify the priority jurisdictions and regulators for cross-border coordination in connection with crisis management, recovery and resolution planning, and implementation. Based on the onbalance sheet and off-balance sheet information reported by each of the top eight U.S. SIFIs, the FDIC has identified 12 priority jurisdictions that are host to over 97 percent of the total reported foreign activities of the top U.S. SIFIs. Of these 12 jurisdictions, over 90 percent of the SIFIs' total reported foreign activities are in two jurisdictions, the United Kingdom and Ireland. The FDIC is conducting robust outreach in these priority jurisdictions.
- *Jurisdictional Survey:* In addition to these heat mapping exercises, the FDIC is conducting a survey on the legal and regulatory regimes in the priority jurisdictions. The survey assists us in identifying the obstacles to effective cross-border resolution and cooperation and the coordination measures we may

[1] 15 U.S.C. 1639d(b).
[2] 76 *Fed. Reg.* 11598 (March 2, 2011), proposing amendments to Regulation Z, 12 C.F.R. 1026.35(b)(3).

take with fellow regulatory and resolution authorities to mitigate such obstacles.

- *Participation in Crisis Management Group Meetings:* Under the auspices of the Financial Stability Board, the FDIC and its U.S. and non-U.S. banking regulatory authority colleagues are working in Crisis Management Groups on recovery and resolution strategies for each of the global systemically important financial institutions identified by the G20 at their November 4, 2011, meeting. The work of these Crisis Management Groups, consisting of both home and host authorities, is intended to enhance cross-border institution-specific planning and cooperation for a possible resolution, should it become necessary. The work also allows regulators to identify impediments to a more effective resolution based on the unique characteristics of a particular financial company and the jurisdictions in which it operates.

Q.3. In your view, what additional steps must be taken with respect to the cross-border resolution of a SIFI?

A.3. In our view, the following additional steps must be taken with respect to the cross-border resolution of a SIFI:

- Dialogues with foreign resolution counterparties must continue. Many jurisdictions are in the process of amending their resolution regimes and we are following these developments with great interest.
- As jurisdictions develop resolution strategies for their respective SIFIs, we must understand their impact on the U.S. operations.
- The FDIC is in the process of understanding the usage of financial market utilities by each SIFI and the impact of a SIFI's entry into Title II receivership on its membership and processing arrangements with financial market utilities.
- Through the review of the Title I resolution plans or "living wills" and enhanced heat mapping exercises, the FDIC will gain transparency on the location and usage of each SIFI's data and profit centers, as well as location where liquidity is concentrated.
- The FDIC is working with fellow regulators in determining the extent of information with respect to each SIFI that may be shared on a confidential basis with other resolution authorities in connection with our cross-border coordination efforts on crisis management, recovery and resolution planning, and implementation.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM MARTIN J. GRUENBERG

Q.1. During the June 6th hearing, Mr. Gruenberg agreed that "historically, including to the present day, the biggest risk of banking is the lending activity that is inherent to the banking process."

In testimony before the Subcommittee on Financial Institutions and Consumer Protection on May 9th, the former Chief Economist

of the Senate Committee on Banking, Housing, and Urban Affairs stated:

> In a remarkably understated 2007 annual inspection report on Citigroup, the Federal Reserve Bank of New York observed that "[m]anagement did not properly identify and assess its subprime risk in the CDO trading books, leading to significant losses. Serious deficiencies in risk management and controls were identified in the management of Super Senior CDO positions and other subprime-related traded credit products." By the end of 2008 Citigroup had written off $38.8 billion related to these positions and to ABS and CDO securities it held in anticipation of constructing additional CDOs. [Testimony of Marc Jarsulic, Chief Economist, Better Markets, Inc., before the Senate Committee on Banking Housing and Urban Affairs Subcommittee on Financial Institutions and Consumer Protection, "Is Simpler Better? Limiting Federal Support for Financial Institutions", May 9, 2012.]

According to accounts of the hearings held by the Financial Crisis Inquiry Commission, two witnesses agreed that CDOs were responsible for Citigroup's financial difficulties:

> [Former Citigroup chief executive Charles] Prince ultimately blamed much of Citi's problems on CDOs, which he said were complex and entirely misunderstood. He said the company, its risk officers, regulators and credit rating agencies believed CDOs were low-risk activities. As it turned out, they resulted in $30 billion worth of losses . . .
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> [Former Comptroller of the Currency John] Dugan, too, put much of the blame on CDOs, partly as a way of defending his own agency. He said the bank, which the Office of the Comptroller of the Currency oversaw, did not damage the holding company, while Citi's securities broker-dealers, which managed the CDOs and were overseen by the Securities and Exchange Commission, were at fault.
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> "The overwhelming majority of Citi's mortgage problems did not arise from mortgages originated by Citibank," Dugan said. "Instead, the huge mortgage losses arose primarily from the collateralized debt obligations structured by Citigroup's securities broker-dealer with mortgages purchased from third parties."—Cheyenne Hopkins, "No One Was Sleeping as Citi Slipped", *Am. Banker,* Apr. 8, 2010.

Do you agree with the New York Fed, the former Comptroller of the Currency, the former Chief Economist of the Senate Banking Committee, and the former CEO of Citigroup that CDOs were a substantial cause of Citigroup's financial difficulties in 2008, resulting in significant support from the Federal Government, including capital injections from the Treasury Department, debt guarantees from the FDIC, and loans from the Federal Reserve?

A.1. Without getting into the specifics with respect to Citigroup, I agree that CDOs and other model-driven, structured products

played a substantial role in the most recent crisis. Many banks viewed the creation of these products as a means to fund lending activities and shift credit risk off balance sheet. Unfortunately, as these products continued to develop, they resulted in untenable concentrations of systemic risk and leverage in products that, by their very nature, lacked transparency. The popularity of these instruments as investment vehicles increased dramatically as the senior-most tranches received the highest investment-grade ratings, and their coupon rates dramatically exceeded the steadily declining Federal Funds and U.S. Treasury rates. The high investor demand for CDOs placed considerable stress on banks and nonbank mortgage brokers to underwrite the significant volume of mortgages that ultimately backed the CDOs. This resulted in the weakening of underwriting standards and the issuance of poorer quality CDOs.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM MARTIN J. GRUENBERG

Q.1. On December 31st, Section 343 of the Dodd-Frank Act, addressing unlimited FDIC-insurance coverage for noninterest bearing transaction accounts, is scheduled to sunset. As you know this section was based upon the FDIC's Transaction Account Guarantee Program. Whether or not TAG is extended through the end of the year, it is clear that this type of supernatural Government involvement cannot be maintained indefinitely. Can you advise the Committee whether any alternatives exist, or which are under consideration by the FDIC, that would instill the confidence our small businesses and our local governments need to avoid having to pull payroll or transaction accounts from their local community banks since each Friday it seems that these folks read about some local bank being put on the FDIC's receiverships list?

What precisely has the FDIC done to foster the development of private sector solutions to TAG?

A.1. From the FDIC's standpoint, the most effective action that bank regulatory agencies can take to maintain the confidence of small business and local Government depositors in their community banks is to ensure that these banks strengthen their capital and liquidity positions. To the great credit of community banks, with the encouragement of bank examiners, they have significantly strengthened their capital and liquidity over the past several years. As of June 2012, the average leverage capital ratio for banks with less than $1 billion in assets was 10.3 percent, almost exactly what it was at the end of 2007, when it was 10.4 percent, and more than it was at the end of 2002, when it was 9.6 percent. As of June 2012 the average ratio of short-term assets to short-term liabilities for commercial banks with less than $1 billion in assets was 105.7 percent, compared to 84.7 percent at the end of 2007 and 86.7 percent at the end of 2002. These actions by community banks to increase their capital and liquidity are, in fact, a strong private sector response to the issue of maintaining confidence.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM MARTIN J. GRUENBERG

Q.1. When Congress passed the Volcker Rule provisions of the Dodd-Frank Act, Congress intended to give regulators the authority to exclude venture capital funds from the definition of "covered funds." In a recent study, the FSOC recommended "that Agencies carefully evaluate the range of funds and other legal vehicles that rely on the exclusions contained in section 3(c)(1) or 3(c)(7) and consider whether it is appropriate to narrow the statutory definition by rule in some cases."

Do you agree that you have the authority and discretion to exclude venture capital funds from the definition of "covered funds?"

Do you agree that sound venture capital investments lead to job creation and economic growth?

A.1. Section 619(h)(2) of the Dodd-Frank Act defines the terms "hedge fund" and "private equity fund" as "an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine." This definition, as written, would cover the majority of venture capital funds.

As part of the Notice of Proposed Rulemaking (NPR), the agencies sought public comment on whether venture capital funds should be excluded from the definition of "hedge fund" and "private equity fund" for purposes of the Volcker Rule. In Question 310 in the NPR, the agencies ask:

> Should venture capital funds be excluded from the definition of "covered fund"? Why or why not? If so, should the definition contained in rule 203(l)-(1) under the [Investment] Advisers Act be used? Should any modifications to that definition of venture capital fund be made? How would permitting a banking entity to invest in such a fund meet the standards contained in section 13(d)(1)(J) of the [Bank Holding Company Act]?

Sound venture capital investments, like other investment activities, can contribute to job creation and economic growth. In conjunction with the development of the final rule, the agencies are reviewing public comments responding to the NPR, including comments on Question 310 related to venture capital funds. The agencies will take these and all comments into consideration in the development of the final rule.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WICKER FROM MARTIN J. GRUENBERG

Q.1. Section 165 of the Dodd-Frank Act requires certain nonbank financial companies and each bank holding company with total consolidated assets of $50 billion or more to periodically file a Resolution Plan, or "living will," for the company's resolution in the event of material financial distress or failure, and to report on the nature

and extent of each company's credit exposures. In implementing this requirement, please explain:

Whether and to what extent the FDIC will compare Resolution Plans submitted by each institution to assess how many have identified the same issues in their plans and whether that might have systemic risk implications.

A.1. The FDIC's plan review process is designed to include a "horizontal review" of certain identified topics expected to be addressed by each institution. This horizontal review includes an analysis of the strategies of each institution put forward for its material entities, as well as the various resolution regimes (such as bankruptcy for holding companies, receiverships for insured depository institutions and administrations for foreign entities) under which the material entities will be required to be resolved, identified obstacles, related mitigants to those identified obstacles, and the assumptions upon which the institution relies to support the feasibility of those strategies.

This comparative review will help to focus on key systemic issues that have been raised in the industry domestically as well as globally. The review will include:

- interconnections and interdependencies such as cross company borrowing, lending, or shared services;
- the treatment and booking of derivatives, domestically and cross-border
- the impact of qualified financial contracts;
- the ability to separate and substitute core business lines and critical operations; and
- the reliance on common global payment systems and financial market utilities and infrastructures.

Additionally, the comparative review and assessment will help to identify gaps and areas that may require further regulatory consideration and guidance in order to strengthen the oversight of systemically important financial institutions.

Q.2. To what extent regulators have ascertained the costs to the private sector of preparing Resolution Plans. (Has the FDIC considered asking each company to compile a cost of assembling such a plan?)

A.2. Each of the companies that were required to submit plans by July 1, 2012, expended significant resources in developing their resolution plans, representative of the seriousness placed on these plans and the challenges associated with a first time reporting requirement. In addition to the dedication of internal staff resources, many of these initial companies, which included the largest and most complex financial institutions, also hired external legal, accounting, and general consulting firms to support their efforts. The FDIC has not asked each company to compile the total cost of assembling such plan. In conjunction with the 165(d) rulemaking, the FDIC developed some preliminary estimates of the hours that would likely be required to complete the initial plan submissions, which assumed an internal preliminary estimate of 9,200 hours for an initial full report by the largest institutions and approximately half that amount for others. Once baseline plans are established,

we would anticipate the burden to be substantially less in future years. These estimates did not include the cost of systems upgrades and other investments that firms may make in order both to comply with the ongoing requirements and to better manage resolution risk.

Q.3. Whether the FDIC intends to report to Congress or otherwise release any information about what the FDIC has learned as a result of receiving such information.

A.3. Please see response to Question 2.

Q.4. Whether the FDIC expects that its review of the initial Resolution Plans will form the basis of revising the requirement for the institutions required to file by July 1, 2013.

A.4. Yes, we expect that the FDIC and the Federal Reserve Board (FRB) will provide further guidance to those institutions that are required to submit initial plans by July 1, 2013, that will be informed by our review of the first submissions. These initial plans will inform the FDIC and FRB as to whether the guidance provided to the firms needs further clarification, and which assumptions provided to the firms should be modified. Through a comparative review of the plans, we expect to identify the approaches which best address the intent of the resolution plan requirement and facilitate FDIC and FRB review.

We also anticipate that guidance for those institutions required to file by July 1, 2013, may be modified beginning in the fourth quarter of 2012 because of the nature of those firms relative to the initial filers, which included some of the largest and most complex financial institutions.

Q.5. With respect to the FDIC's stated intention to resolve a failing financial institution by placing the top-tier holding company into the orderly liquidation authority and continuing to operate all of the subsidiaries, how, if at all, this approach should affect the content or direction of a Resolution Plan.

A.5. The "Living Wills" are the firms' plans to resolve themselves under the U.S. Bankruptcy Code and therefore the plans should not be affected by the FDIC's strategies for resolving the firms under Title II of the Dodd-Frank Act.

Q.6. Whether the FDIC intends to report to Congress or otherwise release any information about what the FDIC has learned as a result of reviewing Resolution Plans.

A.6. The public portion of the plans are currently available to the public on our Web site and have been the subject of considerable analyst comment.

Q.7. Whether Resolution Plans will be used in enforcement actions.

A.7. The Resolution Plans are not being sought for the purpose of developing or supporting an enforcement action. If, however, a situation arises in which a Resolution Plan (or a portion of it) would constitute relevant evidence in an enforcement action, there is no prohibition on the FDIC or another appropriate Federal regulator using it for that purpose.

Q.8. While the Dodd-Frank Act does not appear to require that an institution make any part of its Resolution Plan public, Federal

regulations seem to permit an institution to prepare a public section (with the institution exercising its own judgment about what information is proprietary and should not be disclosed). Does the FDIC plan to second guess those judgments? Does it plan to issue any further guidance about the content of the public section?

A.8. 12 CFR Part 381.8(c) sets forth the required elements of the public section of a resolution plan filed pursuant to section 165(d) of the Dodd-Frank Act. The FDIC intends to review the public section of each resolution plan for compliance with this subsection of the regulation. Based on this review, the FDIC's Office of Complex Financial Institutions may add to or amend one or more of the required elements. However, there are no specific plans to do so at this time.

Q.9. With regard to the confidential portion of a Resolution Plan, will the FDIC accord it the same degree of confidentiality that it accords reports of examination? If not, why not, and what degree of confidentiality would the FDIC extend to such information? How widely will the FDIC share a Resolution Plan with other banking regulators?

A.9. Yes, the FDIC will provide the Resolution Plans with the same level of confidentiality as accorded to reports of examination. Section 112(d)(5)(A) of the Dodd-Frank Act (18 U.S.C. §5322(d)(5)(A)) requires the Federal Reserve Board and the FDIC to maintain the confidentiality of any data, information, and reports submitted under Title I (including the resolution plans prepared and submitted as required under section 165(d) of the Dodd-Frank Act), and the FDIC fully intends to comply with that legal requirement. The FDIC has implemented security practices for the plans to ensure that we maintain their confidentiality consistent with applicable exemptions under the Freedom of Information Act (5 U.S.C. 552(b)) and the FDIC's Disclosure of Information Rules (12 CFR part 309).

The FDIC will share the resolution plans with other banking regulators to the extent permitted by law.